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FINANCING WORK-RELATED ENTITLEMENT PROGRAMS: AN UPDATE

A REPORT

PREPARED BY THE
CONGRESSIONAL RESEARCH SERVICE

FOR THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

JANUARY 1985

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LETTER OF SUBMITTAL

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January 24, 1985

The Honorable Pete V. Domenici
Chairman, Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Last year you and the Ranking Minority Member, the Honorable Lawton Chiles, asked the Congressional Research Service to provide your Committee with an updated version of a report, "Financing Work-Related Entitlement Programs," that CRS initially prepared for the Committee in April 1983. This earlier report was a comprehensive analysis of the methods of financing the Federal government's major entitlement programs whose eligibility and benefit amounts are determined by work histories and levels of salaries/wages. The programs identified by your Committee for such analysis included social security, medicare, civil service retirement, military retirement and railroad retirement. The April 1983 report included a detailed analysis of each of the programs, tracing the history of financing and expenditure control issues, assessing short-run and long-run financing problems facing the programs and discussing proposals for program reform that were being considered. An Overview chapter compared and contrasted program financing methods and program costs and benefits with each other and with private pensions, using a common set of economic and demographic assumptions in doing the analysis. To our knowledge, analysis using such a consistent methodology had not been done previously for this set of programs.

The updated version of this study, hereby submitted to your Committee, includes an extensive revision of the Overview section of the earlier report. This revision constitutes Parts I and II of the updated report. It has been written to reflect legislative and other program changes since the earlier report. The estimates are based on economic and demographic assumptions from the 1984 Report of Social Security's Board of Trustees, and include baseline budget estimates of the Congressional Budget Office as of August 1984.

We believe the individual program chapters from the April 1983 report stand as comprehensive historical documents. Readers interested in this historical perspective are referred to this earlier report. ("Financing Work-Related Entitlement Programs"; S. Print 98-48; April 1983). Part III of the updated version includes shorter individual program chapters that (1) discuss the most recent legislative changes (for example, the Social Security Amendments of 1983), (2) update official program performance data and projections, and (3) discuss recent proposals for program changes.

P. Royal Shipp managed this project and wrote Parts I and II of the study. The individual program chapters in Part III were written by analysts and specialists in the Education and Public Welfare and Foreign Affairs and National Defense Divisions of the Congressional Research Service:

Janet Kline	Medicare
Geoffrey Kollman	Social Security
Dennis Snook	Civil Service Retirement
Robert Goldich	Military Retirement
Dennis Snook and Michael Burke	Railroad Retirement

Michael Burke provided research assistance and Leona Barber editorial assistance throughout the project. Under contract with CRS, Edwin Hustead of the Hay Huggins Co., Inc., assisted with actuarial methodology, estimates and projections.

I hope this study will provide background and perspective to the Committee and to the Congress in considering the important issues in work-related entitlement programs.

Sincerely yours,

Gilbert Gude

Gilbert Gude
Director

LETTER OF TRANSMITTAL

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United States Senate

COMMITTEE ON THE BUDGET
WASHINGTON, D.C. 20510

MEMORANDUM

TO: SENATE BUDGET COMMITTEE MEMBERS

DATE: JANUARY 23, 1985

SUBJECT: REPORT ON "FINANCING WORK-RELATED ENTITLEMENT PROGRAMS: AN UPDATE"

In April 1983 the Senate Budget Committee published a report on financing the federal government's largest entitlement programs--those whose eligibility and benefits are established by work histories and earnings records. Since publishing this analysis, the Congress has amended the laws affecting most of the programs, and new estimates of future program size and growth have been made by actuaries of the agencies responsible for program management.

Consequently, the Committee asked the Congressional Research Service (CRS) to update the basic information about these five important programs--Social Security, Railroad Retirement, Federal Civilian Retirement, Military Retirement, and Medicare. We sought to provide Committee members and the Congress as a whole with an examination of the major legislative changes made in these programs over the past two years and an analysis of the financial status and budgetary impact of these programs.

We believe the report which has now been completed will be of considerable help to the Budget Committee, as well as to other Congressional committees and individual members, as they consider the financing of the programs addressed in this report.

Issuance of this report as a Budget Committee print does not, of course, in any way imply that the Committee endorses the conclusions stated or the information presented.

We thank the CRS for the extensive effort required to produce this report. We commend the individual staff members, whose names are listed in the letter from Gilbert Gude, for their dedicated work.

Lawton Chiles
Ranking Minority Member

Pete V. Domenici
Chairman

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Part I

Overview

(By P. Royal Shipp)

Introduction

Many government and business spokesmen expect that "entitlement" [1] spending will be closely examined as the Federal Government attempts to gain control over its budget expenditures and over the large Federal deficit. One reason is that entitlement outlays account for a major share of Federal spending. Moreover, some of the large entitlements face internal financing problems from time to time. Recently, the Congress remedied acute trust fund problems of the largest entitlement, social security, as well as those of a small one, railroad retirement. Although not yet an immediate problem, medicare still faces potential depletion of its rapidly shrinking hospital insurance trust fund.

The share of the Federal budget listed in the entitlement column has grown rapidly in recent years, to 50 percent in 1983. Most entitlement benefits go to retired or disabled workers and to their dependents and survivors; a relatively small share goes to the needy of the Nation through welfare programs. Two large areas of Federal expenditure not analyzed in this study have entitlement characteristics: agricultural subsidies to farmers and interest on the public debt.

Years of work and levels of earnings establish eligibility for the largest entitlement programs. Individuals become eligible for welfare entitlements if they fit into a qualifying group and have low income and resources.

This report analyzes a subset of entitlement programs, namely work-related entitlements. They are: social security (old-age, survivors, and disability insurance), medicare, civil service retirement, military retirement, and railroad retirement. According to Congressional Budget Office August 1984 estimates, these programs collectively will spend $304 billion in 1985, more than one-third of the Federal budget and about 8 percent of the gross national product (GNP).

The report establishes a framework for analyzing issues of work-related entitlements by comparing their financing techniques and operations. For example, social security and deferred compensation benefits have similarities in program design, but also differences in

[1] The concept of entitlement, as a way to distinguish a particular type of Federal program, is used throughout this report. The concept itself, while useful for certain types of analysis, lumps Federal activities together which have vastly different objectives. For example, obligations for deferred compensation, social insurance, and means-tested welfare programs all are entitlements. Furthermore, there is no authoritative agreement on the list of programs that are entitlements. These distinctions and issues are discussed in part II, chapter 2.

program objectives. Such a comparison, expanded to include private sector pension and insurance programs when appropriate, provides the necessary background for dealing with issues of financing and expenditure control in retirement programs. Medicare shares social insurance objectives with social security, but its benefit structure sets it apart from retirement analysis methodology.

Part I of the study is an overview of the entire report and includes a summary and conclusions.

Part II of the study analyzes financing concepts, sources of funds, and shortrun and longrun costs and trust fund operations. It argues that the amount of benefit obligations arises from legislated benefit formulas and that sources and types of financing to pay the benefit obligations are separate matters altogether. Part III presents a brief discussion of recent legislative changes in the five work-related entitlement programs, together with trends in program expenditures, the most current projections, and proposals for change that are being considered. Projections of severe trust fund shortages beginning in the 1990's in the medicare hospital insurance program highlight the need for an extended discussion of this question. Accordingly, the discussion of the medicare financing issue in part III is somewhat more detailed than for the other four work-related entitlements.

Part II of the report uses common sets of economic and demographic assumptions to project costs and analyze financing of three large work-related entitlement programs that provide retirement, survivor, and disability cash income to eligible recipients (social security, civil service, and military retirement). It finds that over the next 10 years, using social security's consensus assumptions (so-called intermediate II–B), benefits paid out by the programs will increase more than 90 percent to $445 billion in current dollars. (In constant 1985 dollars the increase would be 24 percent.) Under more pessimistic assumptions, total expenditures could reach $485 billion (current dollars), 105 percent higher in 1995 than in 1985.

The study also finds wide divergence in overall longrun costs of work-related entitlements when measured against total payroll costs of those programs. It reports that the "normal cost" of social security benefits are expected to equal about 13 percent of payroll, which, when added to a typical complimentary private pension plan would take between 21 and 28 percent of pay. The current civil service retirement system costs 32 percent of pay, somewhat more than the typical private sector experience. The military retirement system, which includes different work force management goals, costs the largest amount, 42 percent of pay. Civil service retirement and military retirement typically cost more than social security supplemented by private pensions largely because of early retirement privileges and full inflation protection in programs for Federal civilian and military employees and retirees.

Financing and Expenditure Control

The problems of paying for social security, medicare, civil service retirement, military retirement, and railroad retirement present Congress with a dilemma. With annual Federal budget deficits in the range of $200 billion or more projected for the remainder of this decade, levels considered unacceptably high by many experts, the Congress will be under pressure to consider reductions in spending in all programs. These five work-related entitlement programs constitute one-third of the total budget and many recent deficit-reducing proposals include reductions even in these potentially sensitive programs. However, program benefits are considered "earned" rights by recipients and workers and have proved resistant to reductions. Accrued rights to these entitlement benefits, established in authorizing legislation, are based on work histories and earnings records developed over a working career. If Congress reduces accrued commitments either for people on the benefit rolls or for active workers, it devalues these commitments, in certain respects, retroactively. Furthermore, benefit obligations from civil service, military, and railroad retirement programs are similar to private sector pensions and are regarded as being deferred compensation.

Though politically difficult to do, Congress can change accrued entitlement commitments by amending the underlying statutes that set forth the conditions for receiving the entitlement. This differs from the case of private contracts which are generally legally enforceable according to their terms by either party. While individuals can sue to insure receipt of benefits under the existing statutes, suits to prevent Congress from changing the law to diminish accrued entitlements, whether social insurance or deferred compensation, have not been successful. Entitlement commitments established by the Congress are statutory rights only, not contractual rights. Thus, Congress retains the power to modify statutory provisions granting entitlement benefits at any time, subject to certain constitutional limitations. Constraints against reducing these entitlements by statutory change are political and moral, not legal.

Pressures to reduce benefits from work-related entitlements develop as Congress struggles to curtail increases in Federal outlays, to reduce budget deficits, or to shore up program financing. Expenditures for the three largest retirement programs for entitlement benefits are part of Federal outlays, a part that has grown rapidly over the past three decades. While expenditures are projected to continue growing in the future, they will decline slightly as a percent of gross national product (GNP) for the 20-year period 1985–2005. As a percent of GNP, the four retirement programs decline from 5.9 percent in 1985 to 5.1 percent in 2005. (Official projections assume medicare's growth will continue to exceed GNP growth.)

Work-related entitlements make up almost one-third of budget outlays, and in the final analysis it is primarily their size and growth, not the level of their trust funds, that lead to concern in the present budget context. Given the size of these programs and

their continued growth in absolute terms, they will be attractive targets for some people who would seek to reduce the Federal deficit.

Congress' dilemma is worsened by public confusion and misunderstanding about the way we now pay for work-related entitlement programs. The five work-related entitlement programs are all financed through trust funds. (Military retirement had been funded through annual appropriations until this year, but changes enacted in the defense authorization bill in September 1983 established a trust fund for this program also.) There is a general, but mistaken, perception that Government trust funds have economic and budgetary effects that are analogous to trust funds used to finance pensions in the private sector. For private pension plans, accrued rights to benefits earned or deferred compensation, are legally enforceable rights and the Employee Retirement Income Security Act (ERISA) has established a variety of requirements governing the accumulation and investment of reserves. Most importantly, ERISA does not allow pension funds to be invested in a company's own securities. Eventually, private plans should have sufficient funds set aside so that at the time of retirement the fund will be large enough to pay the benefits accrued. Thus, benefits will not have to be paid out of current operating revenues.

Although similar in appearance to private pension funds, Federal Government trust funds do not and cannot in themselves insure availability of funds to pay future entitlement benefits. The goal of Federal fiscal policy is to balance appropriately the amount of revenues brought into the Federal Government from all sources, including payroll taxes and employee contributions for work-related entitlements, against the total amount paid out of the Federal Treasury for benefit payments and all other Federal expenditures. A principal concern of fiscal policy is the effect of overall revenues and expenditures, and any deficit or surplus, on the economy. From this perspective, benefit payments for work-related entitlement programs will affect the economy in much the same way as other expenditures, and the payroll and other earmarked taxes will be viewed as an overall source of revenue rather than a revenue earmarked for a particular purpose. This situation holds whether social security is "on" or "off" the budget. In this context, the trust funds for those programs function largely as a mechanism to insure sufficient funds for making benefit payments on time without the need for annual appropriations.

While this analysis emphasizes the economic and budgetary effects of financing work-related entitlements through trust funds, it is recognized that this emphasis ignores some features of and distinctions among trust funds which often weigh importantly in congressional policy concerning program financing. For example, a trust fund shortfall puts pressure on Congress to cut benefits. On the other hand, substantial social security trust fund balances in the past have made it easier for Congress to raise benefits.

Furthermore, concentrating solely on the economic and budgetary effects overlooks fiscal discipline that advocates of trust fund

financing claim is built into the financing mechanisms of social security. The costs of increasing program benefits (or even maintaining current levels) must be matched with necessary trust fund revenues to pay for them. If trust fund shortages occur, explicit action by the Congress is required to cut benefits or to increase the program's resources.

The social security trust fund, in contrast to the civil service and military retirement fund, receives most of its resources from special earmarked payroll taxes whose only purpose is to pay social security benefits. This special earmarking may strengthen the political commitment to maintain payments as long as there are securities in the trust fund. As a result of changes to program financing made by the Social Security Amendments of 1983, social security trust funds have started to build up. With moderate economic growth and temporarily favorable demographic conditions, the social security trust funds are projected to grow to $39 billion in 1985 and to $585 billion by the end of 1995.

Under the moderate set of social security assumptions, the fund would continue to grow through 2025 (in 1984 dollars) and then begin to decline. Under more pessimistic assumptions, the fund would grow through 2008. In either event, demographic conditions favor social security until well into the next century and, assuming reasonable economic behavior, any subsequent "crisis" in program financing has been pushed well into the next century. If the intermediate economic and demographic assumptions are correct, the trust fund would continue to automatically appropriate the necessary benefit outlays for several generations.

At the beginning of fiscal year 1984, the military retirement system funding became similar to the civil service retirement system. This funding basis differs from social security in that it relies on intragovernmental bookkeeping transactions to maintain a trust fund. Although this new financial scheme does not affect overall Federal budget outlays, it may have certain desirable psychological and accounting aspects. The public and military personnel may be more aware of the longrun cost of the system than if the Federal Government merely paid each year the excess of the outgo over the employee's contributions. In the case of the military retirement system, the Defense Department part of the budget will be charged with the actuarial current costs, thus moving the emphasis from payments for retirees to payments for current personnel. These differences in accounting for retirement benefit obligations, however, will not change current or future total budget outlays.

All trust fund assets, including social security's, consist of the Federal Government's own securities, which are, in effect, IOU's the Government has written to itself. Under current law, benefits can be paid only if there are trust fund balances. However, regardless of the size of trust funds, benefit payments can be made only when the Government acquires the resources in a specific year—whether they come from taxes, other revenues, or money borrowed from the public. In essence, benefits are paid by the transfer of re-

sources from the current generation of workers and taxpayers to the current generation of retirees. Measured by economic and budgetary effects, Federal Government work-related entitlement programs are de facto pay-as-you-go systems whether they have trust funds or not, whether the trust funds are large or small, whether the trust funds are growing or shrinking. The ability of the Government to borrow from the public, to tax, and to create money, not trust fund assets, stands behind retirement benefit obligations.

The total size of obligations for benefit payments does not depend on whether or not program benefits are paid through a trust fund. It depends instead on the eligibility and benefit rules set up in the program's authorizing legislation. For instance, the entitlement to military retirement benefits was no more nor less binding than the entitlement to civil service retirement benefits before 1984 although the military retirement system had no trust fund at all while the civil service retirement system had a relatively large and growing trust fund. The requirement to pay beneficiaries their legally specified amount at the legally specified time does not depend on the existence of a trust fund. And, the entitlement to benefits in both programs is established by law and can be changed for either program by subsequent law.

Revenues and expenditures from each trust fund must be analyzed to identify the budget impact. In the case of the military retirement system, the only budget effect is total outlays since there are no employee contributions. In the civil service retirement system, employee contributions count as Federal revenues and are subtracted from total outlays to derive the net budget effect. While most revenues to the social security fund come from payroll taxes, there are substantial intragovernmental transfers. Most notably, the social security trust fund is credited with appropriations necessary to pay for military service, and the fund will be credited with proceeds from the tax on social security.

Income to the social security trust fund is projected to exceed expenditures for the next 40 years creating a reserve in the year 2025 of $2.5 trillion (in 1984 dollars). In 1 year alone, 2010, social security revenues are projected to exceed expenditures by $160 billion. As mentioned before, however, a substantial amount of this income is from intragovernmental transfers. In fact, revenues received by the Government for social security payroll tax and the tax on benefits are projected to exceed expenditures only until 2020.

When social tax revenues exceed expenditures (as is projected until 2020), the social security system creates a source of revenue for the rest of the Government, by lending money to the general treasury. During these years, these "excess" tax funds arguably could be used to reduce the Federal Government's need to borrow from the public, reducing holdings of Government securities by the private sector thus lowering its interest costs.

This analysis is based on the assumption that the goal of overall fiscal and monetary policy during this period will produce Federal Government revenues and expenditures in the proper balance to

support the strongest possible economic activity. In this sense, when payroll tax revenues exceed benefit payments, the extra dollars are indeed used to finance other activities of the Government.

The converse is true when benefit payments exceed payroll tax revenues, as they are expected to starting in 2021. In this case, even with a huge trust fund on hand, the Government will have to raise other taxes, reduce other expenditures, or borrow from the public starting in the first year and continuing in each succeeding year that benefit payments exceeded tax revenues. As long as the trust fund has a positive balance, outlays for benefit payments will be automatically appropriated, but if taxpayers in 2021 decided that they did not want to pay higher taxes or loan more money to the Government, benefits could be cut by statutory changes, regardless of the size of the trust fund.

A major concern of policymakers is the overall relationship between Government revenues from all sources compared to overall outlays, and the effect of this fiscal policy on the economy. Thus, in times of large-scale budget deficits, there will be pressure to reduce all expenditures regardless of the size of the trust fund. On the other hand, it does seem likely that existence of a large trust fund would make social security and other programs with special earmarked sources of revenues politically more difficult to cut than would be the case if there were trust fund shortages.

In the civil service retirement and military retirement programs, the Federal Government is not only the payor of benefits, but the employer as well. Trust funds become less significant when applied to such programs. Military retirement has had, until this year, no trust fund at all and benefit payments were simply made each year from general fund appropriations.

The total present value of benefit obligations for military retirement is calculated to be nearly one-half trillion dollars. If the military retirement system ceased enrolling new members today, payment of accrued entitlement benefits of this amount would have to be made, subject to subsequent changes in law, until the last beneficiary was removed from the rolls. The new trust fund of the military retirement system will not directly affect the size and incidence of the Government's obligations to pay benefits.

The civil service retirement system has had a trust fund from its beginning in 1920 and calculation of the total amount of the Government's accrued obligation for civil service retirement is similar to that of military retirement. However, its financing arrangements have been substantially different. Only part of the total obligation is "unfunded" in an actuarial sense, with the remainder being funded (on the books of the Federal Government) by assets held by the civil service retirement trust fund. As long as the trust fund assets are invested in the Government's own securities, an addition to these assets does not really set aside resources, nor does it prefund retirement benefits.

Neither the size of a trust fund nor whether it is growing or shrinking has an effect by itself on Federal outlays or deficits, now or in the future. These are determined by benefit obligations to

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which workers and retirees become entitled—whether for civil service or military retirement and whether or not these programs have trust funds. Measures taken by the Government as employer to prefund results in IOU's the Government writes to itself. The entitlement obligation to make payments follows from the benefit provisions of the law, not from trust fund balances. The civil service retirement and the military retirement programs could be fully funded on the books of the Government without changing the size of Government outlays or the Federal deficit in any way.

Civil service retirement system financing procedures have confused many. A commonly held view is that pensions should be fully paid for by employers and employees during their active careers. However, as long as the Government as employer invests trust fund assets in its own securities, the idea of prefunding has little economic or budgetary meaning. Furthermore, in a pay-as-you-go system, increasing the amount of employee contributions would simply result in making Federal workers pay more of the cost of benefits to retired employees rather than having these benefits paid by taxpayers in general. A very large majority of private pension plans (around 90 percent according to several studies) require no contributions at all by employees, but are all paid by the employer. These employees, however, pay a social security tax that is comparable to the civil service retirement contribution rate.

In summary, benefits from the Government's work-related entitlement programs all count as outlays in the Federal budget, leading to continued pressure to cut the programs back as part of overall pressures to reduce Government spending. The programs are largely financed as de facto pay-as-you-go systems with benefit payments coming from revenues and sales of securities to the public each year. However, program benefits all follow from benefit obligations accrued over a career of work, and benefit reductions devalue these accrued commitments retroactively. Because entitlement commitments are, in effect, political commitments, political means will be used to protect these entitlements against statutory devaluation.

Retirees and most workers argue that since entitlement rights are accrued over a long time period, any changes should be phased in gradually. Supporters of work-related entitlement programs claim that changes should be made primarily for longrun structural reasons, and not solely for the purpose of shortrun budget balancing. In fact, some would argue that it was budget pressure that limited structural changes on social security last year and in years before. However, without the pressure of the budget or some program financing "crisis" to force consensus and decisions, longrun structural reform is unlikely—particularly if its purpose or effect is to reduce benefits. The difficulty of reaching consensus on the need for program reduction in the absence of trust fund deficiencies is compounded by disagreement over the appropriateness of congressional action which would not take effect for many years. Projecting the need for longrun changes is made hazardous by unpredictable longrun economic and demographic conditions. Because benefits are financed on a pay-as-you-go basis, and benefit obligations

are political rather than legal, the extent to which a current generation of lawmakers should take action that could constrain the options for future Congresses becomes itself a controversial issue.

Conclusions

Despite their diverse histories, objectives, and means of financing, some general conclusions can be drawn from an analysis of the work-related entitlement programs as a group:

(1) Funding for work-related entitlement programs is effectively pay-as-you-go despite the trust funds through which benefit payments are made. Pay-as-you-go systems require the current generation of workers to pay the benefits for the retired generation, whether from payroll or general fund taxes.

(2) Work-related entitlement programs have grown rapidly in the four decades since World War II ended—particularly since 1970. Total program expenditures will have grown fivefold in current dollars in this decade and a half, from under $50 billion in 1970 to a projected total of $304 billion in 1985. (In constant 1985 dollars, program outlays approximately doubled during this 15-year period.) This rapid growth took place because (1) additional persons came on the rolls, (2) economic growth was rapid, and (3) program liberalizations were made during the 1950's and 1960's, reflecting favorable economic and demographic conditions and outlook. In addition, some liberalizations were made in the early 1970's before it was evident that rather anemic economic growth would characterize that decade (and the early years of this one). Full cost-of-living indexing for programs, continued salary growth, and increases in newly eligible beneficiaries would result in additional program growth into the future, although at a slower rate than the gross national product until well into the next century.

(3) Using entry age normal cost as a measure, benefits from civil service retirement and military retirement cost more as a percentage of payroll than those from most plans in the private sector that combine social security with a private pension. Nearly all funds to pay benefits in these two large Federal pension programs come from general revenues (100 percent for military retirement and 80 percent for civil service retirement). In 1985, military retirement will cost 42 percent of payroll and civil service retirement, 32 percent. These are contrasted with approximately 21 to 28 percent for the combination of a typical private sector plan and social security.[2] Most significant in explaining the larger cost for civil service and military retirement are early retirement provisions and full cost-of-living indexation. By itself, social security cash benefits cost 13 percent of payroll. This lower amount underscores social security's role as a basic income floor for most workers, upon which additional sources of retirement income should be built.

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[2] Source: Congressional Research Service, Designing a Retirement System for Federal Workers Covered by Social Security, House of Representatives, Committee on Post Office and Civil Service, Committee Print 98–17, January 1985.

(4) Adequacy of work-related entitlement retirement benefits depends largely on a substantial attachment to the work force, and, for most retirees, on having sources of retirement income that supplement social security. If benefit adequacy is measured against income prior to retirement, work-related entitlement programs pay most retirees with full work careers amounts sufficient to maintain their standard of living in terms of income (taking into account preferential tax treatment of some retirement income) except for those receiving *only* social security. This is true for hypothetical workers at the low end of the income scale as well as near the high end. In fact, depending on the type of benefits, some retirees would see their after-tax incomes actually increase after retirement.

(5) If the value of a retirement benefit is thought of as an asset that provides an annuity for the remainder of one's life, these benefits would represent the largest asset in the balance sheet of most families. For persons with the same number of years of work and the same salary levels, these asset values range widely depending on the nature of the career. For a person age 65 who retires after 40 years of work with the final salary of $30,000, the present value of the asset varies from $123,000 for social security by itself to $887,000 for a person who served 20 years in the military and then worked 20 years in private industry. Civil service retirement benefits when combined with 10 years in private industry have a value of $501,000, about 56 percent of the military benefits. The private pension/social security combination is valued at approximately $278,000.

(6) Medicare, a work-related entitlement program, shares some financing features with the other programs included in this analysis, but it is a health insurance program. The hospital insurance part of medicare is financed through special payroll taxes paid into a trust fund. Medicare costs have risen even more rapidly than the other work-related entitlements because they are tied directly to hospital costs, which have gone up faster than the general rate of inflation. If hospital costs continue increasing at this fast pace, the medicare trust fund will incur vast funding shortages starting in the early or mid-1990's.

(7) The nature of entitlement program allows the Congress to change their eligibility terms and benefit amounts to meet specific policy or financing needs. Basic authorizing legislation, backed up by a consistent chronology of judicial rulings, differentiate these entitlement obligations from binding contracts that enforce vested pension rights in the private sector. The basic commitment of the Government to make payments is established in the eligibility requirements and benefit formulas in the authorization legislation. This basic obligation exists, and can be changed, whether or not program financing functions through a trust fund, whether the trust fund is large or small, and whether it is growing or shrinking. While the constitutional right of Congress to change the conditions of the entitlement is not questioned, benefit reductions have proved difficult to enact. Amounts payable under these entitlements follow from rights to benefits accrued over a lifetime of work. These accrued rights are independent of contributions made

to support that program and their value is reduced retroactively when benefit amounts are reduced. Retirees and many current employees see such benefit reductions as breaking a promise and violating their career expectations and retirement plans. Though legal sanctions are not available, political sanctions are.

Options for Change

Work-related entitlement programs have been under close scrutiny in recent years, both because of their increasing share of the budget and because of recurring shortages in their trust funds. While legislation enacted during the past year corrected, at least for the time being, imminent trust fund shortages in social security and railroad retirement, it is likely that this scrutiny will continue in future years for both reasons.

At the present time, the hospital insurance (HI) portion of the medicare program faces the most severe trust fund shortages, and this program's financing and benefit expenditures consequently will come under attack. Under current law, benefit payments under hospital insurance can be made only if trust fund balances are adequate. According to the report of the 1983 Advisory Council on Social Security, which focused solely on the medicare program, present financing arrangements will provide sufficient trust fund reserves only until the early 1990's, after which the deficit is expected to grow rapidly in the absence of financing changes.

Congress took action to shore up similar trust fund shortages in social security and railroad retirement last year. While the financial condition of the railroad retirement trust fund seems assured for the foreseeable future, some residue of skepticism remains concerning the premanence of the financial health of the social security trust funds.

This suspicion persists because of the very low level of reserves and similar assurances of financial adequacy in the trust funds after the 1977 social security amendments, assurances that went sour after only a few years. In addition, the margin for error is small during the remainder of the 1980's, and a recession within the next few years could put the trust funds in jeopardy again. Furthermore, social security's future trust fund adequacy is based on economic assumptions that, although moderate by standards of the 1950's and 1960's, are more optimistic than economic performance of the 1970's and the early 1980's.

In addition to these concerns about the margin for error in the trust funds, some social security experts have long considered this program to have flawed mechanisms and have advocated basic changes in social security's financing and benefit structure. These experts view the 1983 amendments as cosmetic, not dealing adequately with the underlying structural problems of social security. They point out that a significant portion of the near-term shortfall was alleviated by infusions of general revenues, shifting the burden from the trust fund to the general fund.

Civil service retirement and military retirement face no immediate trust fund shortages and funds will become larger each year, primarily because of intragovernmental funding transfers. Civil service retirement benefits are paid by the general fund, except for the amount, one-fifth of the total, coming from employee contributions. Federal employing agencies allocate an additional one-fifth, but this payment ultimately comes from the general fund. Military retirement benefits are paid entirely from the general fund. If benefit reductions were made in these programs, it would not be due to trust fund shortages, but rather to a congressional determination that they were too expensive compared to other national priorities. Further cutbacks in these programs would most likely be motivated by the perceived need to reduce the size of the Federal budget and its deficit.

General options for reducing budget expenditures and increasing trust fund balances for work-related entitlement programs are outlined below. Each of the individual program chapters in part III of this report includes a more specific treatment of selected proposals for program reform. While most proposals for change assume that the programs are structurally sound and that any needed adjustments can be accomplished by reducing benefits or raising revenues, some recent proposals would substantially alter the basic structure of the programs.

Basic Restructuring

President Reagan and others declared social security financially sound as a result of the 1983 amendments. Whether this is true depends on the accuracy of economic and demographic assumptions that undergird projections of future benefit payments and trust fund revenues. Similar declarations of program financial health in the 1970's went sour repeatedly as the economy faltered through most of the decade. Funding crises during the late 1970's and early 1980's generated proposals for "privatization" of the system. Privatizing social security usually means that workers under a certain age would be able to withdraw from the system and invest the amount of their payroll taxes in an individual account or similar financial instrument in the private sector, which, it is argued, would yield greater return. While such a system would place more responsibility for retirement planning on individual workers and would allow workers to earn retirement benefits directly related to their individual contributions, it would also erode the redistributive aspects of social security, and thus would repeal its social features. Opponents note that it would put a tremendous burden on the current generation of workers, who would have to prefund their own retirement benefits and continue to pay the unfunded benefits of existing retirees and workers above the age cutoff. Calls for such sweeping reforms have fallen off since enactment of the 1983 amendments which repaired social security's immediate trust fund problem.

Medicare's dwindling trust funds have brought forth a wide array of legislative proposals aimed at putting the program back on sound financial ground. To date, the heavy use of general funds

in the hospital insurance portion of medicare has not been considered at length. The hospital insurance program portion is now financed largely by payroll taxes and critics fear the introduction of general funds would provide a welfare taint to the now work-related program. This is why a means or income test to limit benefits has not been given indepth consideration. The Social Security Amendments of 1983 mandated a new prospective payment system for hospital reimbursement under medicare. Most observers think this is having and will continue to have a dampening effect on hospital costs.

The administration's 1983 budget advanced a proposal to eliminate the current railroad retirement system. Under this proposal, these retirees and workers would have been put in the regular social security system and the private pension part of railroad retirement would have been moved into the private sector, with the Federal Government having no further obligations for benefits under this part of the program. The proposal did not face the question of repayment for past work credits earned but not funded. The administration subsequently backed off and accepted the more standard solution (a combination of benefit cuts and tax increases) of the 1983 amendments. Serious attention to future dismantling proposals is unlikely if the economic and demographic assumptions underlying continued trust fund solvency prove out.

The 1983 social security amendments covered all new Federal employees, and some existing civil service retirement participants (the President, Members of Congress, etc.), by social security for the first time. While the social security amendments did not change the current civil service retirement system (CSRS), a new system will have to be designed for Federal workers who are covered by social security. Inclusion of Federal employees in social security had long been proposed, but was opposed by many groups representing Federal retirees and employees who favored an independently structured and financed retirement system.

The administration's 1984 budget proposals, submitted on January 31, 1983, proposed severe reductions in benefits and increases in employee contributions for the current CSRS. Although the budget for fiscal year 1985 did not include the severe changes to the current CSRS, it did propose somewhat reduced benefits and higher employee contributions (see the chapter on the CSRS in part III of this report). In addition, the President's Private Sector Survey on Cost Control (Grace Commission) advocated basic changes in the current CSRS that would reduce its benefits, both in the short run and in the long run.

Military retirement program planners and budget specialists claim the military retirement trust fund's requirement for funding will affect future military manpower decisions by requiring decisionmakers to budget for longrun pension costs in the current year, although these are bookkeeping requirements and do not affect total program benefit obligations. Perhaps the most basic restructuring proposal to surface for the military retirement system is to end the 20-year full retirement provision—a costly program fea-

ture. In 1984, the Quadrennial Review of Military Compensation (QRMC) investigated the issue of changing the military retirement system. In this process, the QRMC used an analytical approach that measured the effect of any proposed change on the budget and on the force structure. The four proposals presented by QRMC would trade large lumpsum payments during service, or at retirement, for long-term savings through benefit reductions. Since the individual's view of the future value of money was assumed to be less than the Government investment rate, the four plans would save money but retain the current force structure. The proposed cutbacks would have increased the full retirement age, reduced the accrual rate, and/or lowered the COLA's. The military establishment has defended the current system as necessary to maintain a youthful and vigorous fighting force and to allow for military promotions.

Reform Options Retaining Current Structure

In addition to basic restructuring, other proposals to correct financial imbalances have concentrated on raising revenues or cutting benefits. The recent social security amendments enriched trust fund revenues by increasing the social security tax, delaying the cost-of-living adjustment 6 months, directing some income tax funds and general revenues into the social security trust fund, and covering employees of the Federal Government and nonprofit organizations. For civil service retirement, where employee contributions pay one-fifth of benefit costs, and for military retirement, with no employee contributions, additional revenue could be raised by increasing the contributions from civil service employees (proposed in the administration's 1984 and 1985 budgets), and requiring them for the first time for military retirement. One obvious alternative for paying medicare's burgeoning bill is through raising taxes—payroll, income, excise, or consumption. Railroad retirement taxes were already increased in 1983 to stave off trust fund bankruptcy and further tax hikes appear unnecessary for the future.

Benefit cuts can be made to have shortrun (up to 5 years) effects, or to alter costs in the long run. The 1983 social security and railroad retirement amendments cut benefits both ways. If changes designed to reduce shortrun costs appreciably are desired, they must reduce benefits for those currently on the benefit rolls. Historically, this has been extremely difficult to do. The change most frequently resorted to has been to reduce automatic and full cost-of-living adjustments (COLA's). When shortrun benefit cuts have been seen as necessary, Congress has favored putting the brakes on COLA's. COLA cutbacks already have been enacted in all work-related entitlement programs except medicare where benefits rise automatically with hospital costs. Additional COLA reduction proposals have been advanced—for example, restricting benefit increases to 2 or 3 percentage points less than full growth in the Consumer Price Index (CPI). There are a variety of ways to cut COLA's, often accompanied by the rationale that during the latter part of the 1970's, a flaw in the way the CPI measured housing costs caused it to increase more than needed to keep retirees up with the cost of living. Price growth also outstripped wage growth

in this period with the result that recipients of fully indexed Federal benefits (social security retirees and others) maintained their standard of living while workers, whose taxes paid for retirement benefits, suffered a decline in their standard of living. Lowering the cost-of-living adjustment is usually thought to be the least objectionable way to cut benefits in the short run because recipients would not have their benefits reduced below what they had been accustomed to; they simply would not receive as large an increase. Reductions in the cost-of-living adjustment are sometimes portrayed as affecting recipients only one time, after which the benefits would be back to normal. However, under most such reductions, even a one-time COLA cut would reduce benefits each year, for as long as the retiree continued to receive them. It would represent a permanent reduction in the base against which future increases would be made.

Longrun reductions usually are designed to affect benefits of current workers who have not yet retired and for whom retirement may be some years away. These include adjusting benefit formulas to make them less generous or extending the age at which retirement can begin. Examples are: the railroad industry's minimum for retirement with unreduced benefits which was changed in the Railroad Retirement Solvency Act of 1983 from age 60 to age 62 for employees turning age 60 after July 1984, and social security's retirement age for full benefits, which will be lengthened gradually to 67, rather than the current 65, starting in the year 2000. The Grace Commission proposed to raise the age for unreduced retirement benefits for the CSRS from 55 to 62. Another example of a revision to save money over the long run was made when, in 1981, the military retirement system was changed to base pension amounts for personnel entering after 1981 on the average of high 3 years of salary rather than the last year.

These changes can be phased in over long periods of time and can be designed to reduce program expenditures by substantial amounts. However, if such changes affect current workers and retirees, they devalue retirement credits already accrued. It is clear that the Congress has the legal authority to do this; moral obligations and political constraints tend to restrict such changes to times of program crisis.

Proposals to strengthen financing of the medicare program break into several basic approaches: increasing premiums or copayments, limiting the amount paid to health providers, and increasing competition through a voucher system.

In October 1983, the Federal Government began to pay hospitals an amount set in advance for particular kinds of medicare cases. Previously, medicare had paid whatever costs hospitals reported respectively. The new prospective payment system appears to be effective in limiting hospital cost increases.

Under the voucher approach, beneficiaries could elect to receive services through a private health benefits plan, including certain health maintenance organizations, rather than through participation in the present program. Most legislative proposals now before

Congress combine the first and second approaches. For a more complete description of medicare financing issues, see part III of this report.

Part II

Work-Related Entitlement Programs: Issues of Financing and Expenditure Control

(By P. Royal Shipp)

Chapter 1

BACKGROUND AND HISTORY

The air of urgency surrounding the financing and expenditure control of work-related entitlement programs is a relatively new development. In the past, the support of policymakers for entitlement programs was based on unprecedented prosperity following World War II. Favorable demographic conditions, combined with steady improvement in real wages and overall productivity gains, cushioned the impact of early cost increases in work-related entitlement programs. These favorable economic and demographic conditions generated support for entitlement programs among policymakers and beneficiaries, with little opposition from taxpayers.

Growth of entitlement programs was incremental and cumulative. They grew in size and scope more as a result of laws that added to or amended previous policies than because of sweeping changes in ongoing practices. Medicare, the health care financing programs for the elderly and disabled (enacted in 1965), is an exception to this generalization. Over time these entitlements came to represent a central commitment by the Government to the people: entitlements to future social insurance and public pension benefits are now among the largest and most important assets of most American families. Actual benefits already paid have played a major role in preventing poverty among those no longer expected to work because of age or disability.

Work-related entitlement programs are products of the democratic political processes that prevail in the United States, evolving at different times and for different reasons, mainly during this century, and responding to national social, economic, and demographic forces.

Commercial enterprises and industrial organizations have always faced the problem of old or disabled employees. Before the development of modern corporations, formal methods for solving this problem did not exist. In fact, attempts at solution were likely to be only informal arrangements for continuing a portion of salary to faithful but infirm employees. Businesses were controlled by relatively few individuals, so that even when the prosperous employers did establish regular support for aged or disabled workers, they could not assure continued payments. Legacies were uncommon, endowments practically unheard of. Thus, arrangements to support elderly and disabled workers were gratuities—benefits backed up

by neither permanent institutions nor assets to which former employees had legal rights. Instead, old-age (or disability) income protection was either the responsibility of the individual employees or their families, or were voluntary gifts deriving from the benevolence and prosperity of employers.

Industrialization, with its steady migration to cities, intensified problems of old age and disability. Not only were there fewer employment opportunities for the elderly and disabled in the city, but urban living fragmented the extended family structure upon which previous generations had depended for support. The anonymity of city life diminished the identity of individuals, and with it the basis for much of the kindness benevolent businessmen had bestowed upon their aged employees.

Yet, twin developments of urbanization and industrialization also alleviated some of these problems. Opportunities for enterprise were boundless, and although opportunities for failure also abounded, the unpredictability of individually owned business was gradually supplanted by the financial and organizational advantages of the corporate structure. A large pool of available workers, combined with economics of large-scale operations, created a trend toward business organizations of great size and perpetuity.

As corporations increased, the need to organize labor resources combined with a humanitarian concern for aged and disabled employees. The practice of assigning light work to these individuals gave way to informal, charitable plans granted by management to specific individuals. Eventually these led to standardization of age, service, and pension amounts as corporations with superior retirement policies began to gain advantage in the competition for skilled workers.

Workers on farms would have counted as friends persons with whom familiarity was a natural result of geographic proximity, but upon moving to the city, workers began to identify common interests with others engaged in the same work. At the same time, corporations were examining formal retirement procedures as a personnel tool, and nascent labor associations were pressing for seniority rules aimed at preventing the arbitrary dismissals of older workers with long service.

Workers who shared common fears about unsafe working conditions began to assume a common responsibility for the victims of misfortune and their dependents. In a tradition reaching back to 18th century European guilds, workers expanded the practice of collections in behalf of widows or disabled colleagues by establishing relief societies and special group insurance schemes. In fact, early worker associations in the railroads, the first of the "big businesses," counted insurance and benevolent associations one of their primary reasons for existence.

As industrialization began to weaken the links between the abundance of land and individual economic security, it created greater problems for the aged and disabled, who were no longer as likely to be given the simple, but necessary tasks that on farms

were associated with diminished physical capacity. In time, rational retirement provisions replaced the irregular procedures for removing workers whose pay exceeded the value of their services. An orderly method of retirement had competitive as well as human advantages; it attracted and retained skilled workers. A stable work force helped breed familiarity and the shared interests out of which labor organizations were born. Early labor associations, then, promoted not only insurance and benevolent activities but also seniority rules and the improvement of working conditions.

Since their inception in the mid-19th century, pensions for private employees, as well as military and civil servants, had two purposes: (1) to meet employers' needs for recruiting and maintaining an efficient work force, and (2) to meet income support needs of the elderly and disabled that were increased by industrialization and urbanization.

From the Nation's earliest wars, Government benefits have supported veterans, but it was not until the 1860's that a system resembling the present-day military retirement system began. At first, military retirement benefits were designed not only to reward military fighters for service to their country, but to maintain a "youthful and vigorous" fighting force, objectives still in force. Private pensions began about 1875, mainly as a way to deal with inefficiencies caused by superannuated employees who were obliged to keep working after their productive years had passed because they had no other means of support. Such superannuated employees were seen as a problem for the civil service soon after its beginning in 1883. After continuous efforts extending over 30 years, Congress enacted the civil service retirement system in 1920, with its principal objective to remove humanely superannuated employees from the work force.

The railroad industry is credited with originating private company pension plans in America. As early as 1874, railroads began to replace the relief associations of the previous decade with formal pensions. The reasons usually cited are: (1) the competitive advantages of a stable skilled work force which, in part, was recruited and retained by the promise of retirement provisions; (2) the great size of railroad enterprises which made rational provision for old and infirm workers necessary and practical; (3) the larger proportion of aging workers caused by maturation of the industry; and (4) high accident rates, which caused private insurance companies to be unable or unwilling to grant insurance to individual workers. The relief associations themselves evolved from ad hoc collections in behalf of widows and disabled employees that received their contributions from employees, rail companies, and the railroad public.

The railroad retirement system started during the Great Depression. By this time the need for a social insurance system had been demonstrated by the plight of millions of destitute elderly and unemployed. Railroad workers won the only federally controlled industry pension system, which seemed to follow naturally from longtime Federal involvement with the industry. Its members were ex-

empted from coverage by social security, which was adopted about the same time.

Beginning at the turn of the century, a variety of civil service pension proposals began to emerge, sponsored by representatives of labor, management, and the public. The first Federal pension bill was submitted to Congress in 1897, and in the next 23 years over 100 bills dealing with Federal pensions were introduced. The Civil Service Commission began recommending a retirement plan in its annual report in 1898, and retirement plans for civil servants were included in the Republican Party platform in 1912 and the Democratic Party platform in 1918.

Meanwhile, the Federal civil service was growing rapidly. Between 1883 and 1918, the civil service grew from 131,000 employees to 917,000 employees. With the end of World War I, there was increasing talk of cutting the Federal bureaucracy back to pre-war size. Faced with the need to reduce the size of the Federal payroll and to manage Federal personnel more efficiently, Congress passed the Civil Service Retirement Act in 1920.

The 1920 act generally limited its coverage to permanent competitive employees in the executive branch of the Federal Government and to regular employees of the District of Columbia Government. During the first year after passage, approximately 330,000 employees were covered under the Civil Service Retirement System (CSRS).

Social insurance in the United States lagged behind other industrialized nations; Germany had begun its social security system in 1889. In the early decades of the 20th century, the movement for social insurance gathered momentum in the United States because of lack of income security in old age, death, and disability. This culminated during the depression with the Social Security Act of 1935. The Social Security Act, as originally passed, would have paid benefits only to elderly workers. But in 1939, before the first benefits were actually paid, the act was changed to include benefits for spouses and survivors. Disability insurance (DI) was added in 1956, and medicare in 1965.

Although late on the scene, social insurance programs have grown rapidly and now loom, with overall defense spending, as the largest category in the Federal budget.

Chapter 2

THE NATURE, SIZE AND GROWTH OF ENTITLEMENTS

The idea of entitlement programs seems straightforward. Nonetheless, Government experts have not agreed on a standard and definitive set of programs to be classified as entitlements. In fact, the use of the term, entitlement, to describe certain types of Federal programs and benefits is relatively new, although the programs and benefits themselves date from the earliest years of the country.

The Budget and Impoundment Control Act of 1974, which established the current legislative budget process, defines entitlements as authority:

> To make payments (including loans and grants), the budget authority for which is not provided for in advance by appropriation acts, to any person or government if, under the provisions of the law containing such authority, the United States is obligated to make such payments to persons or governments who meet the requirements established by such law.

Eligibility for entitlements and the size of benefits are established by legislation authorizing the program. Upon enactment of an entitlement program the Federal Government is obligated to pay benefits to all eligible persons. The statutory rules which determine expenditure levels remain largely outside the approprations process. The amounts in the Federal budget each year constitute only an estimate of what will be required to meet the legislated obligation. Some entitlement programs appropriate funds automatically and permanently. For others with annual appropriations, if actual spending turns out to be more than the estimated amount, the Congress must either change the entitlement or come up with the additional funds. To change expenditure levels Congress must change eligibility rules and benefit formulas by revising the authorizing law. But as long as Congress chooses not to change eligibility and benefits, these entitlements constitute a firm obligation of the Government. In case the law is not complied with, eligible individuals and governmental units have legal recourse against the Government. Legal analysis clearly finds that the Congress has the authority to change program obligations but it must do so through

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the authorizing statute. Thus, entitlement to future benefits does not constitute an unabridgeable legal contract right.[1]

The Congressional Budget Act also sensitized Congress and others to the issue of entitlements by setting up a separate process to deal with congressional consideration of new entitlement legislation. Beyond this sensitization entitlements have come to dominate budget issues because of: (1) their size, and (2) their "uncontrollability."

Direct control over entitlement programs is difficult because they deal with politically sensitive issues such as poverty and retirement. They create networks of individuals who depend upon the program's benefits. Most nonentitlement programs are funded by Congress year by year and inaction may leave a program unfunded. In order to make major spending reductions to entitlements, substantive laws must be changed and a political consensus reached as was done in enactment of Public Law 98-21, the Social Security Amendments of 1983. Historically such consensuses have been difficult to reach and usually require a "crisis" due to the program's growth or financing.

While entitlement spending is clearly mandatory spending, there are, in addition to entitlements, other types of mandatory spending. The Office of Management and Budget refers to some outlays as "relatively uncontrollable under existing law." The Congressional Budget Office uses the term, "entitlements and other mandatory spending." While most of these outlays are associated with entitlement programs, some reflect spending from prior years contracts. "Mandatory" or "uncontrollable" spending might also refer to automatic spending provided by permanent or multiyear appropriations for programs that lack some entitlement features.

Selected Major Entitlements

This study initially breaks total entitlement programs in four categories. Most of the study's analysis will focus on a subset of these entitlements.

Deferred Compensation.—Civil service retirement, military retirement, and railroad retirement.[2]

Social Insurance.—Old-age survivors and disability insurance, medicare, and unemployment compensation.

Means-Tested Entitlements.—Supplemental security income; aid to families with dependent children; medicaid; food stamps;[3] and veterans' pensions.

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[1] This draws on legal analysis done by Kathleen S. Swendiman of the Congressional Research Service. See U.S. Congress. Senate Committee on the Budget. Financing Work-Related Entitlement Programs, Appendix C, "Legal Rights of Individuals Under the Social Security Program and Federal Retirement Programs as Contrasted With Private Sector Counterparts," p. 503.

[2] Railroad retirement is listed here as deferred compensation although a part of the benefit (tier I) might more properly be called social insurance.

[3] While there is disagreement over whether the food stamp program is an entitlement, it is included here because Congress generally treats it as one.

Other.—Veterans compensation; agricultural subsidies; and interest on the public debt.

The entitlement program issues faced by the current Congress go well beyond having to deal with proposed new entitlements, although these continued to be advanced from time to time. Analyzing proposals for new entitlements, while important for future budget control, does nothing to solve current budget deficit problems. Historically, entitlements have been small in initial years and became large budget issues only after several years of maturation. The entitlements now being criticized as contributors to the Federal budget ills were, for the most part, enacted long before the Congressional Budget Act was passed in 1974. In fact, the roots of the largest ones reach back into the Great Depression and before.

Major work-related entitlements consist of the five programs that are analyzed in this report. These include both social insurance and deferred compensation programs. (Unemployment compensation, a State-administered, federally financed program is not treated here.)

Means-tested entitlement programs include an income and resource test as a provision of eligibility and benefit amount. Beneficiaries must have income and assets below a prescribed level in order to qualify for benefits.

Veterans' compensation benefits are awarded on the basis of military service-connected disabilities.

Inclusion of interest on the public debt as an entitlement is in dispute. It is commonly separated from entitlements because the nature of the obligation is seen as more contractual in nature. Interest on a debt is considered by many to be more binding because it is part of the basic agreement between lender and borrower and part of an activity that predates the Federal Government itself.

According to the Congressional Budget Office (CBO), entitlements and other mandatory spending programs, not including interest on the public debt, account for nearly half of the Federal budget. (See table 1.) Furthermore, these are projected by CBO to maintain their share of the budget throughout the period 1983–89. While their percentage increase is not as rapid as that projected for defense spending entitlement spending increases substantially in absolute (current) dollars. CBO projects that defense spending in 1989 would be $196 billion larger than in 1983. During the same period, spending on entitlement programs and mandatory spending would go up automatically by $151 billion without authorizing action by Congress, most of that would be for work-related entitlements.

Table 1.—ENTITLEMENT PROGRAMS AND SIZE AND GROWTH IN THEIR SHARE OF THE FEDERAL BUDGET [1]

[Dollars in billions]

	1983	Percent of budget	1989 (est.)	Percent of budget	Percent change in outlays 1983–89
Deferred compensation	$43	5	$60	4	40
Social insurance	252	30	373	27	48
Other entitlements and mandatory spending	105	12	118	9	12
Defense	210	25	406	30	93
Interest on the public debt	90	11	214	16	138
Other programs	144	17	199	14	38
Total	844	100	1,371	100	62

[1] Some totals may not add because of rounding.

Source: Congressional Budget Office, August 1984; 1989 estimate from CBO's Baseline Budget Projections for Fiscal Years 1985–89.

This study analyzes a selected subset of entitlement programs—those whose eligibility and benefit amounts follow from working careers. Entitlement benefits paid out this year under these programs were actually "earned" as long as four decades ago. These work-related entitlements present even greater issues of expenditure control than other entitlement spending, whose rules for eligibility and benefits have a shorter time horizon.

The long-term obligations implied in work-related entitlements lead to problems of expenditure control. Techniques devised by budget specialists and actuaries to measure the cost of these long-term commitments, to estimate their size, and to show them as real liabilities, encourage decisionmakers to consider the longrun implications of current decisions. Unfortunately, these techniques have surrounded the program financing with a virtually impenetrable shield of concepts and procedures. Subsequent sections of this report will attempt to unravel these confusing concepts and terms to make clear how the issues of financial accounting are related to, but differ from, actual program expenditures.

Eligibility for work-related entitlement benefits begins after work ends, and, except for medicare, benefit amounts are derived from the number of years and amount of earnings over an entire work history. This tie to work distinguishes work-related entitlements from other entitlements for which eligibility requires a demonstrated need (e.g., supplemental security income, food stamps, etc.) and is based on an allocation formula (e.g., some grants to States).

According to CBO's August 1984 estimates, total outlays from the five work-related entitlement programs considered in this study will be $304 billion in fiscal year 1985—31 percent of budget outlays of $977 billion (see table 2). The social security cash benefit program (old-age, survivors, and disability insurance—OASDI) is by far the largest of the programs, 19 percent of the total, but medicare has grown more rapidly since its enactment in 1965. These two larger programs constitute the basis of the Nation's social insurance system. Together these two social insurance programs dominate the nondefense budget, spending 27 percent of total Federal outlays, compared to an equivalent 27 percent for defense.

The other three programs analyzed in this report are staff retirement programs that provide deferred compensation to Federal civilians and military workers and to railroad employees. As discussed below, these programs share certain basic pension features with social security. These Federal staff pension programs have similarities with, but also basic differences from their cousins, private pension plans.

Civil service retirement and military retirement are the oldest of the work-related entitlements. Civil service is about one-third larger than military retirement in terms of recipients (about 2 million for the civil service retirement system and 1½ for military retirement) and about 46 percent larger in annual dollars spent (estimated $23 billion and $15.7 billion respectively in fiscal year 1985). Railroad retirement, the smallest of the five programs (1 million beneficiaries and $6 billion of benefit payments), is the only private industry pension authorized in Federal law and controlled by the Federal Government.

Work-related entitlement programs have grown to their present levels from much smaller amounts in 1950. At that time, recipients totaled 4.2 million, while expenditures were $1.8 billion, or 4.3 percent of the total budget.

These five programs make up the bulk of Federal support to the elderly even though a substantial share of the benefits go to people who are under age 65. These spending programs also constitute the basic but not the only Federal contribution to the Nation's retirement income system. Federal Government policies also affect retirement income decisions through regulation of private pensions and through favorable income tax treatment of private pensions and such savings accounts such as individual retirement accounts (IRA) and employment-related capital accumulation or thrift plans.

Medicare, a program of hospital and medical insurance for the elderly and disabled, is included in this analysis because its eligibility depends on previous work history and because it is an integral part of the Nation's social insurance system.[4] Second only to the social security cash assistance program, its size and rapid growth have aroused recent congressional concern, particularly since this

[4] The medicare program should not be confused with medicaid. Medicaid is a State-administered Federal program that provides medical assistance for low income persons who are aged, blind, disabled, or members of families with dependent children.

growth is projected to continue. If it continues at past rates, the program will face funding shortages by the mid-1990's.

Medicare, a health insurance program, differs from the other four programs which make cash benefit payments and share common pension features. Medicare will be excluded from certain parts of the analysis in this report that compare and contrast the three largest cash-assistance programs sharing pension features.

Table 2.—SIZE AND GROWTH OF WORK-RELATED ENTITLEMENTS

[Recipients in millions and dollars in billions]

	1950		1960		1970		1980		1985 est.	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Social security	3.5	$1.0	14.8	$11.5	26.2	$32.5	35.6	$122.1	36.8	$188.4
Medicare						5.3		25.6		71.1
Civil service retirement	.2	.2	.5	.8	1.0	2.8	1.7	15.0	2.0	23.0
Military retirement	.1	.3	.3	.7	.8	2.8	1.3	11.9	1.4	15.7
Railroad retirement	.4	.3	.8	.9	1.0	1.8	1.0	4.9	1.0	6.0
Total	4.2	1.8	16.4	13.9	29.0	45.2	39.6	179.5	41.2	304.2

Note.—The number of medicare recipients is not listed separately since most would be receiving social security. Furthermore, some individuals are receiving two or more benefits. Data for 1985 are from CBO's August 1984 estimates.

The four cash programs pay benefits not only upon normal retirement, but also in case of disability or death. Although the shortrun and longrun costs of disability and survivor provisions are included in the program totals, this report does not discuss the operations and programmatic issues of the disability and survivor programs.

Except for medicare, enacted in 1965, the work-related entitlement programs all predated the "Great Society." Military retirement provisions extend back to the Revolutionary War, and civil service retirement began in 1920. Social security and railroad retirement were enacted in the 1930's as offsprings of the Great Depression.

Although program origins reach well into the past, many current program features that generate expenditure growth were set in motion more recently—in the 1950's, 1960's, and early 1970's—years of favorable economic and demographic conditions. Entitlement commitments that seemed affordable at the time generated the present expenditure levels whose affordability is much less certain.

Favorable economic and demographic conditions ceased in the early 1970's. An ever-increasing number of people became eligible for benefits at the same time as birth rates declined, thereby increasing the future ratio of beneficiaries to workers. Furthermore, in the 1970's and early 1980's, prosperity gave way to intermittent declines in real wages and to high unemployment.

Obligations for benefits already earned under these programs will continue the pressure for expenditure growth far into the future. The future retirement of the large baby boom generation is seen as a longrun threat to the financial soundness of the social insurance entitlement programs. Because of these changes in economic and demographic expectations, a new climate now exists in which concerns about budget deficits and recurring uncertainty about trust fund adequacy, dominate policy debates.

Chapter 3

EARNING VS. FINANCING OF ELIGIBILITY AND BENEFITS

The process one goes through to establish eligibility and earn the rights to a particular level of benefits in work-related entitlements must be clearly specified in statutes and employment agreements. Benefit obligations accumulate over a lifetime of work and are heavily dependent upon the number of years worked and the earnings level achieved during those years. Thus, for each day of work, employees not only receive a specified amount of pay; they also earn a specified amount of deferred compensation to be paid later. In Federal programs, employees earn "entitlement" to these future benefits. The procedures for displaying these obligations on the books of the Federal Government, and the financial arrangements established to pay them, are essentially unrelated to how big the obligations are. That is, the earning of benefits has no necessary relationship to a financing mechanism.

Determining Eligibility and Benefit Amount

Eligibility in all work-related entitlement programs follows from a specified number of years worked in combination with a particular age. Table 1 shows the minimum years needed to establish eligibility. (Usually, a full career worker would accrue many times the number of years shown here.) In most pension and social insurance programs, benefits are not payable until a certain age is reached, even though the amount of benefits is a function of the number of years worked. The longer the work history, the higher the benefit amount, other things being equal. Programs vary markedly both in age and years of work required. As will be shown in a later section, the two programs permitting earliest retirement with unreduced benefits (civil service retirement and military retirement), cost more than private sector counterparts, in part because of these early retirement provisions. If unreduced benefits are paid with 20 years of service, as in military retirement, and at age 55 for civil service retirement, total benefits can be 50 to 150 percent higher than if payments do not start until age 65. Most private sector pensions permit voluntary retirement at age 55, but benefits are reduced.

Table 1.—MINIMUM YEARS OF WORK AND AGES TO ESTABLISH ENTITLEMENT ELIGIBILITY

	Minimum years of work	Ages for unreduced benefit
Social security	10	[1]65
Medicare (hospital insurance)	10	65
Civil service retirement	30, 20, 5	55, 60, 62
Military retirement	20	([2])
Railroad retirement	10	62
Typical private pension	10	62 or 65

[1] Increases gradually to over 67 by 2027.
[2] Any age with at least 20 years of service.

Thus, benefit eligibility is established through a combination of work years and age. The next step in determining benefit amount is to establish the level of deferred compensation earned by each year of work (with the exception of social security which is computed on a career average and medicare where benefits do not vary on the basis of earnings at all). As opposed to cash compensation (salary or wages), the precise amount of which is known when it is earned, the amount of deferred compensation to be paid in the future can only be estimated. The actual amount will depend upon a number of variables, such as years worked, general economic growth, and specific career pattern.

Generally speaking, there are two basic approaches to determining the amount of pension benefits. These are defined benefit plans, which promise a specific benefit when certain eligibility requirements, such as retirement or disability, are met; and defined contribution plans, which set up individual accounts to which employers (and employees in some instances) contribute. The benefit at retirement is based on accumulated contributions and earnings. Although either system can be used to fund the same expected benefits, there can be a significant difference in the actual benefits because of unexpected economic events.

Employers with defined contribution plans set aside a certain amount each pay period, which is then invested on behalf of the employee. The amount accumulated by the employee depends on the amount set aside each period, and on the investment earnings over the entire period. The employee will not know how much his deferred compensation fund is actually worth until he has retired. Thus the risk of investment performance falls on the employee.

Defined benefit plans place the investment risk on the employer. Under these plans, employees are promised a certain benefit upon retirement, which is calculated from a specified benefit formula. These formulas usually grant a certain percentage of final earnings, averaged over 3 or 5 years, for each year worked. Thus the formula insures the employee a benefit amount which depends only on his years of work and amount of final average earnings—with the employer taking the risk for varying economic conditions.

The employer will have to pay the promised amount whether or not the funds set aside to be invested actually compound to the needed level.

Most pensions, especially for large employers, are defined benefit plans.[1] In the private sector, 69 percent of the 30 million persons covered by private pensions are in defined benefit plans. In recent years there has been some movement toward defined contribution plans, particularly as new plans are set up, and as the extent of overall obligations in defined benefit plans has grown. However, many private pension plans include both a defined benefit plan and a (usually) smaller defined contribution plan in the form of a thrift plan or other voluntary capital accumulation plan to which the employee and the employer make matching contributions.

Federal Government pensions are defined benefit plans, including social security, civil service retirement, and military retirement. So are all State government plans except in Nebraska, which has a defined contribution plan.

By using social security and civil service retirement as examples, table 2 demonstrates the important principles of defined benefit plans. These examples assume a work career of 40 years with retirement at age 65. They also assume a final salary base of $30,000, about the average for civil service and higher than the average for social security recipients.

Defined benefit plans devise different ways to base the initial pension benefit on a figure that takes into account productivity and wage increases realized during the working life. In civil service, this is accomplished by basing the initial benefit on the average of the highest 3 consecutive years of salary, usually the last 3. Social security takes the stream of entire lifetime earnings and adjusts each year's wages by the growth in average wages.

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[1] Designing a Retirement System for Federal Workers Covered by Social Security, House of Representatives, Committee on Post Office and Civil Service, Committee Print 98-17, January 1985.

Table 2.—BENEFIT FORMULAS FOR CIVIL SERVICE RETIREMENT AND SOCIAL SECURITY

Benefit formula for civil service retirement: Average of 3 high years = $27,000
Final year earnings = $30,000

1.5%	x 5 years	x $27,000	=	$ 2,025
1.75%	x 5 years	x $27,000	=	$ 2,363
2.0%	x 30 years	x $27,000	=	$16,200
		Total Pension	=	$20,588

Wage Replacement: $20,588 / $30,000 = .69 of final year earnings

Benefit Formula for Social Security; Calculation from Average Indexed Monthly Earnings (AIME); e.g., AIME = $1,482 or $17,784 per year. Final year earnings = $30,000

90%	x $ 211	=	$189.90
32%	x $1,063	=	$340.16
15%	x $ 419	=	$ 62.85

$593 x COLA (11.3%, 7.4%, 3.5%) = $734

Total = $734 per month = $8,803 per year (non taxable)

Total with Spouse = $13,204 per year (non taxable)

Wage Replacement: $ 8,803 / $30,000 = .29 of final year earnings

With Spouse = $13,204 = .44 of final year earnings

As noted in the table, credits earned in the later years of civil service are given greater weight than those earned in the earlier years. Called a "back-loaded" plan, its result is to provide an incentive for employees to remain in Government service if they stay in for 10 years or more. In the social security formula, lower amounts of income earn a greater return on contributions than do high incomes. Called the "tilt" in the social security formula, it is designed to meet social security's social adequacy functions by replacing more income for low income than for high income beneficiaries. The tilt also gives greater weight to earlier years of work—a "front-loaded" plan.

In the examples presented in the table, the ratio of pension received to earnings immediately prior to retirement, a common indicator of pension adequacy, is 0.69 (taxable as income after employee contributions have been recouped) for civil service and a lower 0.29 (nontaxable) for a single social security beneficiary. This means that 69 percent and 29 percent of preretirement earnings are replaced by a pension for civil service and social security respectively. The social security replacement rate goes up to 0.44 for

a couple because social security provides additional benefits for a dependent spouse.

One problem of comparing benefit adequacy among different programs is that tax treatment of benefits is not consistent. In this example, the higher civil service pension is taxable (after the employee's contributions have been paid back) while social security is not. The Social Security Amendments of 1983 (Public Law 98–21) included a provision to tax a portion of social security benefits for the first time, but only if the annual income exceeded $25,000 or $32,000 for a couple. Thus, at the levels assumed in this example, the benefits would not be taxed unless the recipient had substantial additional income.

Despite the differences, there are important conceptual similarities between the different Government plans and between Government and private plans. The principle of earning deferred compensation with each period of work holds for all. These benefit obligations have been earned and it is their cumulative amount that establishes the level of future outlays needed to pay them.

Beyond the similarities and differences in benefit structure lie basic differences between Government and private plans and even among the Government plans themselves regarding techniques that have developed over the years to attempt to insure their financing, and to show them properly as liabilities on the books of the Government or on the books of private businesses. The intent of these procedures is to assist decisionmakers in taking into account the impact of their current decisions on the future obligations of the business or the Government. While this is a laudable purpose in the case of Government pensions, the result of such accounting and actuarial work often is to confuse the relationship between benefit obligations and financing techniques by presenting such programs as though they were prefunded, as private plans are.

Financial techniques can be used to obfuscate the Government's level of real obligations to make benefit payments. Agreement on the nature, usefulness, and functioning of Government trust funds is particularly difficult to reach. The discussion that follows in chapter 4 analyzes how programs are financed and ways to account for the Government's obligations, but not to *determine* the size of these obligations. Chapter 5 discusses how the *size* of the obligation is established.

Chapter 4

THE ROLE OF TRUST FUNDS

Work-related entitlement programs share one feature: they all build up Federal Government obligations. Benefits are paid by the Federal Government and thus require Government revenues from taxes and borrowing from the public. In discussions of the financing issues in work-related entitlements, it is not always made clear how these obligations relate to (1) shortages in the trust funds, (2) the burden of benefit outlays on the Federal budget, or (3) both.

In the final analysis, work-related entitlement benefit obligations are backed by the power of the Government to legislate, not by trust fund balances. This principle holds true whether programs are "self-financed" with most of the income coming from special payroll taxes, such as with social security and the hospital insurance part of medicare, or whether most or all of the revenues come from general income taxes as is true for civil service retirement, military retirement and the supplemental medical insurance (covering physician treatment in certain out-patient settings) part of medicare.

In this chapter, financing issues are discussed from the perspective of trust fund operations. Chapter 5 will examine the program features that determine the size of these obligations and thus the effect of program benefit expenditures on overall budget outlays.

A trust fund is an account set up in the Department of the Treasury to which taxes and other receipts are credited for specified purposes in accordance with the law. A trust fund also serves as a disbursing mechanism for expenditures. In the President's budget for fiscal year 1985, outlays from all Federal trust funds are estimated to be $351 billion, of which the work-related entitlement trust funds constitute nearly 90 percent.

Two trust funds handle financial transactions for the social security cash benefits program—old-age survivors insurance (OASI) and disability insurance (DI)—and two for medicare—hospital insurance (HI) and supplementary medical insurance (SMI). Payments for the OASDI and HI programs come largely from special payroll taxes paid into the trust funds. The SMI program is financed from general revenues (three-fourths) and recipient contributions (one-fourth). The trust fund for civil service retirement is the largest in terms of total dollar balances. It receives most of its assets as intragovernmental transfers from the general fund. Employee contribu-

tions account for one-fifth of total CSRS contributions. The trust fund for military retirement is to be financed totally from intragovernmental general fund transfers.

Trust fund assets for work-related entitlements consist of the Federal Government's own securities. In effect, the Federal Government writes itself an IOU. To the extent earmarked payroll taxes and contributions are responsible for a trust fund buildup, as is essentially true for social security, it is possible to view these trust fund assets as a loan that social security taxpayers have made to the Treasury. Nevertheless, the existence of a trust fund by itself does not insure that benefits will be paid. As long as trust funds are invested in Government securities the only real assurance of benefit payments is the governmental commitment to make benefit payments by cashing in securities, which requires that new revenues be raised, through taxes or by selling bonds to the public. The legal nature of this commitment is little affected by the existence or absence of a trust fund. Having a trust fund available to pay benefits when program outgo exceeds income does not alter the effect on Government fiscal operations. The relationship between revenues to the Government accounts (from taxes and from the sale of bonds to the public) and Government payments to the public affects taxpayers, recipients, consumers, and businesses. Trust fund operations by themselves need have no economic effects.

All Federal pension and social insurance programs with trust funds invest only in Government securities. In effect, these became obligations the Government owes itself, and, as such, they all become de facto pay-as-you-go systems, with all funds needed to make benefit payments in any year coming from taxes or sale of securities to the public in that year, regardless of the size of the trust fund.

Prefunding these programs in the sense that private pensions are prefunded is not feasible unless the trust funds were taken off-budget and invested in securities outside the Government itself, which would give rise to another set of problems. Contrasting the three largest pension programs (social security, civil service retirement, and military retirement) will illustrate.

The new military retirement system trust fund will operate in a fashion similar to the civil service retirement fund. Unlike the civil service retirement fund, however, there are no sources of income from outside the Government. Income to the trust fund will be in the form of Government appropriations from the general revenues and interest on the fund. Thus, just as before, the payment of benefits and expenses will require taxes or the sale of bonds each year.

The relationship between overall Government expenditures and revenues, not the existence of a small or large trust fund, affects the economy. To build up the social security trust fund, more funds come from payroll taxes than go out in benefit payments. Whenever this happens, other taxes will be lower or the Federal deficit will shrink. Regardless of the size of the trust fund, if the amount of payroll tax revenues is smaller than benefit payments, other

taxes will have to be raised or the overall Federal deficit will increase.

The current civil service retirement trust fund receives only one-fifth percent of its contributions from outside the Government with the remainder coming from general fund appropriations. (Of this general fund contribution, one-fifth of the total, matching employee contributions, is shown as an outlay on the books of employing agencies.) This trust fund is growing and will continue to grow into the future according to projections. However, this growth has no effect on Federal Government revenues or expenditures. As noted, revenues from outside the Government come only from employee contributions (7 percent of salary). The employee contribution revenues are estimated at $4.5 billion in fiscal year 1985, making up a fifth of the benefit payments of $23.0 billion. The remainder will come from general funds, in effect increasing the Federal deficit by $18.5 billion.

The civil service retirement trust fund continues growing because funds are credited to it which do not come from outside the Government. These amounts are internal Government transactions, with the Federal Government, in effect, writing itself an IOU.

Government expenditures and revenues and the relationship between them, not the exsitence of a small or large trust fund, are what affects the economy. In the social security system outside income is from employee and employer taxes and payments are for benefits and administrative expenses. These transactions represent most of the operations of the social security trust fund. However, there are substantial and growing intragovernmental transfers such as contributions by the Government as an employer on behalf of Federal employees, and income from investments. Thus, it is possible, but unlikely, that the fund will grow even if social security has the effect of increasing the budget deficit. Regardless of the size of the intragovernmental payments in the trust fund, if the amounts of the payroll tax revenues are smaller than expenditures, other taxes will have to be raised, other programs cut, or the Federal deficit will increase.

In the three programs discussed in the previous paragraphs, the Federal Government is obligated to meet benefit payments prescribed in the program's authorizing legislation. These benefit entitlements constitute the Government's commitment to pay benefits. The obligation to pay military retirement benefits was just as strong before it had a trust fund as it became after. Furthermore, the benefit obligation is no stronger for the growing civil service retirement trust fund than it is for social security with a relatively smaller trust fund. Whether a program has a trust fund or not and whether a trust fund is large or small has no effect on Government outlays or the budget deficit now or in the future.

A trust fund is set up to be a financing mechanism out of which payments must be made. Not only do the operations of the trust funds differ from program to program, but the extent of trust fund shortages differs as well. These shortages require corrective action

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by the Congress. (It should be noted again, however, that trust funds can grow at the same time that these programs contribute to larger budget deficits.

The projected shortages in the old-age survivor and disability insurance trust fund were eliminated for 75 years according to projections accompanying the financing changes made as part of Public Law 98–21, the Social Security Amendments of 1983.

A similar compromise approach was used to solve the fund crisis in the railroad retirement fund with the passage of the Railroad Retirement Solvency Act of 1983.

Even with optimistic economic assumptions, medicare will enter into serious trust fund shortages by the middle of the next decade. This crisis may come sooner if the economy performs more poorly than expected or if medical costs spending itself climb higher than expected.

As already noted, the current CSRS and military retirement have no trust fund shortages, with none expected. Under the current system, trust fund balances will continue to mount in the future. Now that social security coverage has been extended to new Federal workers, financing arrangements for the civil service retirement trust fund may have to be adjusted, but these adjustments could be merely intragovernmental transactions with no effect on the unified budget.

Chapter 5

THE SIZE OF EARNED ENTITLEMENTS: EXPLANATIONS OF RAPID GROWTH

Program Growth: Pressure on the Budget

Benefit payments from all work-related entitlement programs count as outlays in the unified Federal budget. Even though only medicare faces imminent trust fund shortages, and even though the Social Security Amendments of 1983 will remove OASDI and medicare from the unified budget starting in fiscal year 1993, the large size and rapid and relatively uncontrollable growth of the programs have targeted them for particular concern in the context of the unprecedented budget deficits projected over the next few years. Many policymakers and commentators from Government and private business have called for "curbing the rate of growth of entitlement spending" as necessary to gain control over Federal budget deficits.

Specific program decisions made by past Congresses, now in effect, have established benefit rules which will determine near-term benefit obligations in work-related entitlement programs. Even though Congress is not expected to raise benefit levels, benefit expenditures will continue to increase as a result of expanding eligible populations in the two largest programs (social security and medicare). Future real wage growth and price inflation are likely to increase outlays for social security and railroad retirement benefits and those of the two Federal employee retirement programs (civil service and military retirement).

Benefit liberalizations and additional new programs enacted several decades ago joined with expanding numbers of beneficiaries and growth in real wage levels to increase program expenditures fivefold since 1970. More specifically, since 1970 the five programs grew in current dollars at an annual rate of 17 percent. (In constant 1985 dollars, the growth was slower, 9 percent per year.) This rapid growth rate resulted from: (1) the "maturing" of the programs, (2) rapid economic growth during the 1940's, 1950's, and 1960's, which brought about large increases in real wage levels that in turn led inexorably to subsequent increases in earned benefits, (3) addition of programs during the 1950's and 1960's when favorable economic growth and demographic conditions led to optimistic longrun financing forecasts, (4) increases in benefit levels of all programs during the 1950's, 1960's, and early 1970's, and (5) increased

longevity. These sources of future program growth are discussed in the sections that follow.

Maturing Programs

Programs whose eligibility and benefits follow from age and years of work have long startup periods because entitlement to program eligibility and benefits builds up slowly. Financing a pay-as-you-go system is easy in the early years because all workers can be taxed, but benefits go only to a few recipients at first. In 1950, benefit payments for all five work-related entitlements were awarded to 4.2 million recipients. Social security was still in its infancy, having made payments for only 10 years.

The civil service and the military while much older, had relatively small work forces before the 1930's and a correspondingly small number on the retirement rolls by 1950. The number of employees rose dramatically during the Great Depression and even more during World War II. These rapidly increasing potential beneficiaries were working and accruing retirement credits during the 1950's and 1960's, but by 1950, only 190,000 former civil service employees and 130,000 former military employees were on the retirement rolls. Railroad retirement, with an earlier employee buildup, had 400,000.

By the late 1970's and early 1980's, however, the situation had changed. The programs were "maturing," meaning that the relationship between retirees and employees was approaching its ultimate high point. If employment and retirement enrollment continue level after the ultimate point is reached, the ratio of beneficiaries to employees will remain constant. Civil service retirement and military retirement will mature earlier than social security. Railroad retirement is already past the point of maturity.

Social security will not fully mature until the baby boom generation retires in the next century and continued growth in social security costs stems in part from increases in the number of beneficiaries on the rolls. For example, over the next 10 years, the number on the rolls is projected to grow by 6 million.

Rapid Economic Growth

The U.S. economy grew very rapidly during the years following the end of World War II and up to the early 1970's. While periodic downturns in business activity (recessions) marred the economic landscape, these were typically short lived and relatively mild. During the 1960's, the average annual real increase in GNP was 4.2 percent for the decade as a whole, with the rate reaching 6 percent for some years. In contrast, the comparable figure during the 1970's was 3.1 percent.

Substantial economic growth in general translated into high levels of real wage growth. Since benefit obligations earned in defined benefit plans are a function of late career wages or full career indexed wages, wage growth automatically pushes up obligations for social security and pension payments to be realized upon

retirement. Growth in real wages grew strongly during the 25-year period following World War II. During the 1960's, annual real wage growth averaged 4.3 percent. In contrast, the sluggish economy of the 1970's produced annual real wage growth that averaged only 1.3 percent for the decade.

Not only did these years of high economic growth expand pension and social security payments, they also established an atmosphere of optimism with expectations that: (1) these rosy conditions would continue as far into the future as anyone wanted to point and (2) current projections of obligation buildup would be easily affordable. In fact, it was possible to argue for expanded benefits to be paid from productive capacity provided by ever-compounding levels of economic and demographic growth.

As Paul Samuelson stated in a 1967 *Newsweek* article:

> The beauty of social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in. And exceed his payments by more than 10 times as much (or five times, counting in employer payments). How is this possible? It stems from the fact that the national product is growing at compound interest *and can be expected to do so for as far ahead as the eye can see.* (Emphasis added.) Always there are more youths than old folks in a growing population. More important, with real incomes growing at some three percent per year, the taxable base upon which benefits rest in any period are much greater than the taxes paid historically by the generation now retired.[1]

Unfortunately, within a few years after this article was published, economic as well as population growth tapered off markedly.

New Program Benefits

During the 1950's and 1960's, new benefits were added to improve the coverage and protection of work-related entitlements. Easily financed at the time, they have become very costly with maturity. Since rapid economic growth and a favorable demographic outlook characterized these two decades, the new features seemed easily affordable at the time.[2]

Disability insurance was added to social security in 1956, and the medicare program began in 1965. Eligibility for benefits at earlier ages was allowed in social security, railroad retirement, and civil service retirement. The early retirement provision did not increase social security costs because benefits were actuarially reduced for early retirement. However, civil service and railroad retirement

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[1] Quoted in Robert J. Myers. *Social Security,* 2nd edition, McCahan Foundation, 1981. pp. 276–277.

[2] An ever-expanding population may lead to certain problems concerning optimum population size but it makes retirement income programs easier to finance and actuaries classify it as a "favorable" demographic condition for that reason. On the other hand, increased longevity is an unfavorable demographic condition in the eyes of actuaries because it increases program costs.

did not reduce benefits for early retirement, thus adding substantially to future program costs.

Increased Benefit Levels

During the 1950's, 1960's, and even into the early years of the 1970's, benefit increases above increases in the cost of living were enacted. These ad hoc benefit increases, enacted from time to time, more than kept pace with inflation and enabled recipients to participate in the general rise in the national standard of living. The cost effects of such changes were immediate and long run. Since it expands the base upon which all future increases are made, a one-time increase for beneficiaries adds to program costs for as long as the group receiving such a benefit increase is on the rolls. Ad hoc social security benefit increases, enacted prior to automatic indexed adjustments legislated in 1972 were for current beneficiaries and for all future beneficiaries as well. Congress also liberalized the civil service benefit formula several times. The most recent major improvement was enacted in 1969 when the formula was made more generous by calculating benefits on the average of the high 3, instead of high 5 years of salary.

Other benefit increases followed from the nature of work-related programs and occurred automatically. Congress did not have to take explicit action to cause the growth. For example, most programs tie initial program benefits to a measure of final average earnings, which in turn reflects the wage growth due to productivity increases. Thus, initial benefit levels, and therefore all subsequent benefit levels, rise automatically with economic growth.

During the 1960's and early 1970's, a major change was made in program benefit formulas that turned out to be very costly. Benefits from work-related entitlements, and later some income-tested cash benefits were indexed to increase automatically with increases in the cost of living.

Civil and military retirement introduced automatic and full cost-of-living provisions in 1963 and social security moved from ad hoc to automatic and full COLA in 1972. Railroad retirement is also automatically, but not fully, indexed. The part of railroad retirement patterned after social security (tier I) is fully indexed but the rest is only partially indexed. Medicare is not automatically indexed, except for certain deductibles, but its expenditures rise in response to health care inflation.

Full and automatic indexing can be very expensive even in moderate inflation and few private pension plans can emulate the Federal Government in this respect. However, most major employers in the United States provide some form of post-retirement increases. Among State governments, 31 provide automatic increases but these are typically limited to 3 percent in any given year. Almost all of the other States and most private-sector employers have provided benefit increases on an ad hoc basis. One study showed these increases to average 38 percent of cost-of-living increases during a recent 6-year period. Because COLA increases are expensive, the Federal Government has modified the increases in

some recent years and future modifications are part of many budget proposals.

Increased Life Expectancy

The decrease in mortality rates has been slow but steady, adding to program costs. The longer people live, the higher the total payments, since payments continue until death. In 1985, males reaching age 65, on average, can expect to live 14.6 more years, 1.8 years longer than in 1950. For females, the difference is even greater. A woman whose 65th birthday falls in 1985, on average, can expect to live 19.2 years longer—4.1 years more than her 1950 counterpart.

Past and Projected "Real" Benefit Growth

A central policy issue in work-related entitlement programs is the extent to which the "real" value of benefits should be retained. Real benefits, in this sense, usually refers to the amount of benefit after it has been adjusted to take account of the eroding power of inflation. In other words, if the benefit received is constant over time while the cost of living rises, the purchasing power ("real" benefit) will decrease over time. Social security's economic long-range assumptions project consumer price index increases of 4 percent per year, relatively modest in comparison to much of the 1970's and early 1980's. Even so, at this rate of inflation, a benefit of $1 in 1985 would be worth only two-thirds of a dollar in 1995 if there were no cost-of-living adjustments.

As noted in chapter 3 above, the rate of expenditure growth has been rapid in the past, and as will be discussed subsequently, program projections indicate continued future growth. Some, but not all, of this growth follows from inflation, since these programs are fully indexed. Analysis in this section distinguishes the growth caused by inflation (with no increase in real benefits) from growth resulting from additional beneficiaries coming on the rolls and growth resulting from increases in real benefits. Program expenditure growth will occur in these work-related entitlement programs in the future for all three reasons without the Congress taking any action to liberalize benefits or eligibility. This future growth is already built into programs.

Dollar expenditures in social security, civil service retirement, and military retirement grew rapidly from 1970 until the present. Furthermore, continued growth is expected during the next decade. From 1970 to 1985 program expenditures increased annual growth rate of 13 to 15 percent. From 1985–95, program size is expected to grow at a rate of about 6 percent. (See table 1.)

Table 1.—SIZE AND GROWTH OF SELECTED WORK-RELATED ENTITLEMENT PROGRAMS: 1970, 1985, 1995

[Expenditures in billions of current dollars]

	1970	1985 (est.)	1995 (est.)	Annual percent change	
				1970–85	1985–95
Social security	$32.5	$194.1	$369.4	12.7	6.6
Civil service retirement	2.8	23.2	44.1	15.1	6.6
Military retirement	2.8	17.4	32.1	13.0	6.3

Note.—Data for 1985 and 1995 are actuarial projections provided by the Social Security Administration, the Department of Defense, and the Congressional Research Service. The 1985 actuarial estimate differs slightly from budget estimates shown earlier in this study and those that will accompany the Administration's 1986 budget submission. These slight differences are mainly due to different assumptions and the fact that actuarial estimates are for calendar rather than fiscal years.

However, much of this program growth is caused by inflation. Table 2 indicates annual growth rates in 1985 dollars, or with the effects of price inflation taken out. While these data show substantially less growth than numbers with inflation included, growth in beneficiaries and real benefit increases still drive up expenditures. The average annual increase in real 1985 dollars from 1970 to 1985 was 5 to 7 percent, and from 1985 to 1995 is projected to be about 2 percent.

Table 2.—SIZE AND GROWTH OF SELECTED WORK-RELATED ENTITLEMENT PROGRAMS: 1970, 1985, 1995

[Expenditures in billions of 1985 dollars]

	1970	1985 (est.)	1995 (est.)	Annual percent change	
				1970–85	1985–95
Social security	$91.7	$194.1	$240.9	5.1	2.2
Civil service retirement	7.9	23.2	28.7	7.4	2.2
Military retirement	7.9	17.4	20.9	5.4	1.8

Note.—See note on table 1.

The number of beneficiaries on the rolls depends on past work force growth and retirement trends. As shown in table 3, the number of beneficiaries on the rolls grew at the robust annual rate of about 4 percent for civil service retirement and military retirement, reflecting Federal work force and military service growth of earlier decades (the New Deal, World War II, etc.). These programs will continue growing in beneficiaries during the next 10 years also due to work force growth in previous years—but at the slower rate of 1.3 percent per year. The number of social security beneficiaries grew, albeit at the slower rate of 2.6 percent from 1970 to 1985 because of employment growth in the overall economy during those

years, and because increasing numbers of workers were coming on the social security rolls as happens in the early years of all pension programs. (Social security did not start paying benefits until 1940.) Social security beneficiaries continue to grow as this program still will not have completely reached an equilibrium point in its relationship between those coming on to the retirement rolls and those leaving the rolls until after the baby-boom generation retires in the next century. From 1985 to 1995, average annual beneficiary growth in social security will be 1.5 percent, exceeding civil service and military retirement beneficiary growth.

Table 3.—GROWTH OF BENEFICIARIES OF SELECTED WORK-RELATED ENTITLEMENT PROGRAMS: 1970, 1985, 1995

[Beneficiaries in millions]

	1970	1985 (est.)	1995 (est.)	Annual percent change	
				1970–85	1985–95
Social security	$25.2	$36.8	$42.8	2.6	1.5
Civil service retirement	1.01	1.98	2.26	4.6	1.3
Military retirement	.76	1.38	1.57	4.1	1.3

Note.—See note on table 1.

Even after taking out the effects of cost-of-living and beneficiary increases, per capita benefits will grow. These increases are caused by the effect of economic growth on employee salaries and wages. As noted earlier, the level of initial benefits upon joining the rolls is a function of the real wage growth that occurs during a work career. From 1970 to 1985, real per capita benefits grew in all three programs at about 2.6 percent per year for social security and civil service retirement, about double that of military retirement. This relatively rapid rate was made possible by the rapid economic growth from the end of World War II until the early 1970's. Real benefit increases will continue during 1985 to 1995, but at a slower rate as workers on the payroll during the low growth years of the 1970's and early 1980's come onto the retirement rolls with relatively lower levels of real wage growth.[3] Real growth in average benefits per beneficiary during the next 10 years is projected to be under 1 percent per year in all three programs (see table 4).

[3] Much of the rapid growth in initial security benefits in the 1970's occurred because of the unintended results of the interaction of the social security benefit formula with unexpected high rates of inflation. Congress corrected this problem in 1977 by gradually decreasing real benefit levels for people becoming eligible for social security in 1979 and later compared to what they would have been under the old law. Under the new benefit formula, initial benefits for people becoming eligible after 1983 will increase in proportion to the rise in wage levels.

Table 4.—SIZE AND GROWTH OF AVERAGE ANNUAL BENEFITS PER BENEFICIARY: 1970, 1985, 1995

[Benefits in constant 1985 dollars]

	1970	1985 (est.)	1995 (est.)	Annual percent change	
				1970–85	1985–95
Social security	$3,600	$5,300	$5,600	2.6	0.6
Civil service retirement	7,800	11,700	12,700	2.7	.8
Military retirement	10,400	12,600	13,300	1.3	.5

Note.—See note on table 1.

Chapter 6

ESTIMATING THE SIZE OF FUTURE BENEFIT OBLIGATIONS

Projecting into the future is hazardous but necessary for analytical work. Estimating future social insurance and pension program costs has the added difficulty of an extremely longrun future. The social security and other actuaries, for example, make estimates for 75 years. Longrun estimates are necessary to plan for current and future workers and to identify patterns of future benefit obligations.

Economic and Demographic Assumptions

The size and growth of work-related entitlements are inherently sensitive to assumed economic and demographic conditions. Data presented here show projected costs for the short and the long run.

While the actuaries of each of the benefit systems produce official annual reports on expected longrun costs, the projections are based on different economic and demographic scenarios. Simple addition of the data from the reports can thus be misleading, especially in the long run. To present consistent estimates that would be unbiased, the Congressional Research Service developed data based on a common set of economic and demographic assumptions. At the request of CRS, social security and military retirement actuaries provided estimates using social security's midrange and pessimistic assumptions. Using its own computer model, the CRS then produced comparable data for the civil service retirement system based on the same economic and demographic assumptions.

Future costs and financing of social security are calculated using four sets of economic and demographic assumptions. These are designated with roman numerals, I, II-A, II-B, and III. Assumptions I are optimistic; II-A and II-B are considered an intermediate or most reasonable set, and III a more pessimistic set. The social security assumptions are not necessarily more authoritative than assumptions used to value other systems. However, social security assumptions are well known and widely used, and in this report, permit development of a common base upon which comparison projections were made.

Most analysts consider the II-B set of assumptions to be most appropriate and this is the set used by social security to demonstrate

an "actuarial balance" between benefits and contributions. Cost projections shown and analyzed here for all work-related entitlements use assumptions II–B and the more pessimistic assumptions III, suggesting a possible range of costs.

Economic conditions are highlighted because of their dominant influence on shortrun costs, particularly for social security and medicare. Demographic conditions, on the other hand, affect long-run costs.

Tables 1–A and 1–B show key economic conditions affecting work-related entitlement programs. The real wage differential (the difference between an index of wage growth and price increases, thus a measure of economic growth) coupled with the size of the labor force are the most significant shortrun factors influencing the financial health of the social insurance system.

During the 1950's, 1960's, and early 1970's, Americans became accustomed to low unemployment, low inflation, and strong economic growth. If these conditions had persisted, social security's trust fund would not have experienced trouble in the 1970's. However, during much of this decade and into the early 1980's, real wage growth was much lower than had been projected, while unemployment and inflation were much higher, thereby throwing social security's trust funds into two serious crises.

Projections on which future social security financing is actuarially balanced assume the economy will grow at a slower rate than it did during 1950–70. After projected slow growth during the remainder of the 1980's, both sets of assumptions (II–B and III) include a positive level of real wage growth, higher than recent experience but much lower than the postwar years until the 1970's. If there is insufficient economic growth to generate positive real wage growth, social security will continue to have financial problems although the 1983 social security amendments base benefit increases on the lower of price growth or wage growth and thus offer some protection against the financial imbalance that occurred in the 1970's. (See part III, chapter 2 for a more detailed explanation of this point.)

Table 1–A.—ECONOMIC EXPERIENCE AND ASSUMPTIONS

[In percent]

Year	Actual		
	Consumer Price Index (increase)	Real wage differential	Average annual unemployment
1950–54	2.4	3.8	4.0
1955–59	1.6	2.6	5.0
1960–64	1.3	2.1	5.7
1965–69	3.4	2.0	3.8
1970–74	6.1	.2	5.4
1975–79	8.0	−.1	7.0

Table 1-A.—ECONOMIC EXPERIENCE AND ASSUMPTIONS—Continued

[In percent]

Year	Actual		
	Consumer Price Index (increase)	Real wage differential	Average annual unemployment
1980	13.5	−4.9	7.1
1981	10.2	−1.5	7.6
1982	6.0	−.4	9.7
1983	3.0	1.2	9.6

Table 1-B.—ECONOMIC EXPERIENCE AND ASSUMPTIONS

[In percent]

Year	Assumptions					
	Consumer Price Index (increase)		Real wage differential		Average annual unemployment	
	II-B	III	II-B	III	II-B	III
1984	4.7	5.2	1.2	−.1	7.9	8.2
1985	5.3	5.7	.8	−.7	7.5	9.0
1986	5.5	6.0	.9	.4	7.2	8.8
1987	5.2	5.5	1.1	.4	7.0	8.4
2000	4.0	5.0	1.6	1.1	6.0	7.0
2100 and later	4.0	5.0	1.5	1.0	6.0	7.0

Source: Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1984.

Financial performance of civil service and military retirement pension programs is not tied as directly to economic conditions as social security. Financial balance for these two staff pensions does not depend on payroll taxes, sensitive to economic conditions, but are financed mainly from general revenues. In addition, their employment levels are not necessarily affected by overall levels of employment.

In all programs increases in both wages (except medicare) and prices directly affect program costs. Rates of wage growth push up initial benefit amounts, and price increases boost them after retirement.

Financial Conditions for the Shortrun and Intermediate Period [1]

In the shortrun, 1985 through 1995, expenditures for social security, civil service, and military retirement are projected to continue to grow. As table 2 indicates, total benefit expenditures for these three programs will increase by 90 percent (24 percent in constant 1985 dollars) by 1995, if the II–B assumptions are realized; they will increase by 105 percent (24 percent in real 1985 dollars) under III assumptions. This projected growth takes place without any explicit change in law, and it assumes that Congress does nothing to restrain the growth. As noted in chapter 5, the projected growth is caused by:

(1) Continued increases in the cost of living;

(2) Additional recipients joining the rolls; and

(3) Higher initial benefit levels resulting from past wage increases.

A widening gap in costs from different assumptions in alternatives II–B and III occurs during the 10-year period. This difference shows up more in social security. Social security expenditures increase between 1985 and 1995 by $175 billion under II–B assumptions, while under the III assumptions, expenditures would increase by $208 billion for the same period.

Table 2.—EXPENDITURE PROJECTIONS FOR WORK-RELATED ENTITLEMENT PROGRAMS UNDER DIFFERENT ECONOMIC AND DEMOGRAPHIC ASSUMPTIONS, 1985–95

[In billions of current dollars]

Year	Social security		Civil service		Military	
	II–B	III	II–B	III	II–B	III
1985	194.1	196.0	23.2	23.2	17.4	17.4
1986	209.3	211.4	25.0	25.0	18.6	18.7
1987	226.2	227.4	27.0	27.1	20.0	20.1
1988	243.4	245.6	29.0	29.2	21.3	21.5
1989	260.3	264.3	31.0	31.4	22.7	23.0
1990	277.6	284.1	33.0	33.6	24.1	24.6
1991	295.1	305.2	35.1	36.0	25.5	26.2
1992	313.5	331.7	37.2	38.5	27.0	28.0
1993	332.8	355.4	39.4	41.1	28.6	30.0
1994	351.2	379.5	41.7	43.8	30.3	32.0
1995	369.4	403.5	44.1	46.7	32.1	34.2

Source: Office of the Actuary, Department of Defense, Social Security Administration and Office of Personnel Management. Estimates were done in November and December 1984 based on economic and demographic assumptions from the April

[1] Analysis in the remainder of this chapter utilizing short and longrun actuarial data, will concentrate on social security, civil service retirement, and military retirement. Issues in the medicare program are substantially different in nature and will be treated at length in part II of this report. Actuarial data on the railroad retirement system, taking the extensive 1983 amendments into account, are not available.

1984 trustees' report of the social security system. These will differ from budget estimates in the 1986 budget, because, among other reasons, the latter will be based on more recent assumptions. Furthermore, actuarial projections, by nature, differ from budget estimates.

Longrun Obligations

As noted above, projections of future benefits and their costs depend on economic and demographic assumptions. Longrun projections are highly sensitive to demographic factors such as fertility, mortality, and disability. Other demographic factors such as rates of immigration, marriage, divorce, and age at retirement are important to estimates of the work force and beneficiary composition. Actuarial projections are even more sensitive to economic factors, especially growth rates of real wages and levels of real interest rates. Still other economic variables, such as labor force participation and unemployment, also influence cost estimates. For any given set of assumptions about these economic and demographic variables, estimates of future benefits and their costs can be made.

Actuarial projections are not predictions. They are merely extrapolations. Because differences between assumptions and actual experiences are inevitable, projections are subject to considerable uncertainty. It is, however, necessary to adopt one or more sets of assumptions and to project future costs and benefits to ascertain whether a program would be financially sound under specified conditions. Social insurance and pension programs require long-range planning, including longrun estimates.

A few years ago, many analysts viewed social security's intermediate assumptions (called II–B) as overly optimistic for shortrun analysis (over the next 10 years) although II–B assumptions still were widely considered appropriate for longrun analysis. For shortrun analysis, social security's more pessimistic assumptions (III) were thought to represent the economic outlook more closely.

However, the strength of the current economic recovery supports somewhat more optimistic assumptions for the short run. Both are used in this report when appropriate. The National Commission on Social Security Reform used II–B assumptions for its longrun projections. Shortrun estimates were based on a set of economic assumptions developed by the Commission. They were neither social security's II–B nor III, although they were close to the more pessimistic III assumptions.

Longrun projections can be made for different time periods, although for social security and Federal pension programs a projection period of 75 years is common. The function of such longrun projections is to provide early warnings about possible adverse developments. The early warnings, in turn, permit gradual rather than sudden changes to be made when necessary to strengthen the financing of the programs. By updating these projections regularly and by revising assumptions in light of emerging trends, actuaries provide a flexible frame of reference for assessing actuarial balance between income and costs of social insurance and pension programs.

Medicare is financed through Federal trust funds. Actuarial projections are based on additional factors (such as rate of increase of hospital costs) and are usually made for no more than 25 years into the future. Medicare financing issues are treated in part III, chapter 1, and are not analyzed here.

In summary, actuarial projections of future costs and benefits provide information for making responsible longrun plans. These projections, however, are only estimates based on uncertain assumptions about future economic and demographic developments. Whenever either economic or demographic trends shift abruptly, past assumptions and the projections based on them will become obsolete. When such shifts occur, longrun projections permit adequate time to consider what adjustments are appropriate to meet the changed circumstances before a crisis sets in.

Longrun Costs as Percent of Payroll

Longrun cost analysis for social insurance and pension programs requires concepts and techniques not used in the shortrun analysis. Longrun costs frequently are expressed not in dollars, but in "percent of payroll." This measure is calculated by dividing the total benefits in a year by the total wages and salaries. Percent of payroll is used because dollar amounts become so large in the long run that they are meaningless if stated in nominal dollars. Percent of payroll provides a common denominator for nominal values that change over time. Even assuming only modest inflation rates, say 4 or 5 percent, the frame of reference becomes lost. Expressing costs as a percent of payroll permits: (1) retirement benefits to be compared with wages and salaries paid, (2) analysis of total compensation, and (3) comparison of relative costs among plans.

Longrun costs in this report are expressed according to two different concepts for funding them: intergenerational transfer (pay-as-you-go) and advance funded. Pay-as-you-go funding assumes that the costs of retirement benefits to a group of retirees will be paid by the generation of workers still working. Workers' taxes, both payroll and general revenues, will finance payments to retirees. On the other hand, advance funding sets money aside during the working life of an employee so that retirement credits can be accrued. The concept of advance funding is most appropriate to private pensions where reserves must be invested in securities outside the organization. Under requirements of the Employee Retirement Income Security Act (ERISA), and Internal Revenue Service (IRS), funds should be large enough so that the funds set aside during the working career, together with the interest earned, will be sufficient to pay the promised annuity to the retired employee over his remaining life. Advance funded systems are required to pay off or amortize any projected shortfalls or "unfunded liabilities" over a 30- or 40-year period. This adds substantially to advance funded costs because most plans, upon inauguration and when plans are modified, make accrued benefit rights available immediately to employees with past (unfunded) work service. Furthermore, any bene-

fit increases arising from unanticipated experience create new unfunded liabilities.

Both pay-as-you-go and advance funded methods were used in this study to estimate longrun costs of social insurance and pension programs. Irrespective of the system used to measure costs, however, the de facto practice for funding the Government retirement systems is the pay-as-you-go approach. (See part II, chapter 4 above.) The medicare system is funded on this basis. Railroad retirement, once partially advance funded, has become a pay-as-you-go transfer system. The civil service social security, and military retirement systems are partially advance funded on the books of the Government, but, because the funds are internal to the budget and constitute an IOU the Government has written to itself, these funding systems become, in the final analysis, pay-as-you-go systems.

Even in a pay-as-you-go system, there are good reasons for calculating costs under the advance funding concept. One reason, more pertinent for Government retirement systems than for social security, is to inform taxpayers of the accrued costs of benefits for current workers. Finally, an advance funding measure may be used as a guide even when advance payments are not made. The advance funding measure is often used to (1) compare the costs of Government and private sector retirement plans, (2) measure total compensation, (3) determine the cost of Government employment, and (4) assign the costs to the appropriate functional categories of the budget.

This report shows longrun costs for three of the programs—both as pay-as-you-go systems and as advance funded systems. (See table 3.) The advance funded comparisons are substantially higher because they include figures representing the cost of amortizing unfunded liabilities. However, after 40 years the advance funded systems would usually be less costly because unfunded liabilities would be fully funded and only payment of the normal cost (defined later in this text) would be required.

As noted earlier, longrun costs are typically presented as a percent of covered payroll. In pay-as-you-go systems, an estimate is made of the amount of benefits to be paid in each year, then divided by the total amount paid in salaries and wages to active employees in that same year. This ratio is the percent of payroll needed to finance benefits. The 75-year average over the actuarial period is the longrun cost expressed as percent of payroll. Of course, the payroll is different in each program. Social security's covered payroll includes all salaries and wages against which social security taxes are charged, but in pension programs, the payroll is simply the amount their own agency or industry pays out in wages and salaries.

Table 3 also shows longrun costs for these work-related entitlement programs under different economic and demographic assumptions. Calculations are presented using both actuarial concepts, pay-as-you-go and advance funding. The advance funding cost estimates show the level of funds that would have to be set aside from

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current workers: (1) to pay off benefit rights already accrued by employees and retirees, and (2) to fully fund their own eventual retirement. The "entry age normal cost" is the amount needed to fund pension costs for a cohort of entering workers. Normal cost plus the cost of amortizing unfunded liabilities equals the total advance funded cost of a system.

Table 3.—LONGRUN (75-YEAR) ACTUARIAL COSTS OF WORK-RELATED ENTITLEMENT PROGRAMS

Plans	Cost on two bases as percent of payroll				
	Pay-as-you-go intergenerational			Advance funding	
	II-B	III		II-B	III
Social security	13.0	17.2	Normal cost	13.4	17.6
			Amortization of liability.	7.5	7.9
				20.9	25.5
Military retirement	51.9	55.3	Normal cost	41.7	44.9
			Amortization of liability.	42.9	47.1
				84.6	92.0
Civil service retirement.	37.1	39.4	Normal cost	32.2	34.6
			Amortization of liability.	22.0	23.0
				54.2	57.6

Source: Actuarial projections, using social security II-B and III assumptions from the 1984 trustees' report. These data were provided by the Office of the Actuary in the Social Security Administration and the Department of Defense. Costs for the civil service retirement system were calculated using the CRS model. To insure completeness and consistency, needed modifications of the data were made by Hay Huggins.

From the beginning, social security was conceived not as the sole source of retirement income, but as a base on which to build retirement income. Indeed, only 12.3 percent of families with a person 65 or older receive income from social security only. The longrun cost of social security, on an entry-age normal cost basis, looks relatively modest, at 13.4 percent of payroll (II-B assumptions) or about 40 percent the cost of civil service and one-third the cost of military retirement. A typical private pension, integrated with social security, is itself worth 10 to 13 percent of payroll, and, if this were added to social security, and a capital accumulation plan were included, a combination typical in the private sector benefits from this combination would be valued at 23 to 28 percent of pay.[2]

[2] "Designing A Retirement System for Federal Workers Covered by Social Security . . . ," U.S. House of Representatives, Committee on Post Office and Civil Service, Committee Print, No. 98-17, January 1985.

Civil service and military retirement are costly primarily because they are fully indexed, and because they have liberal early retirement privileges.[3] In the military retirement system, indexed payments can begin after 20 years of military service. These benefits will be received during the remainder of the individual's life regardless of other sources of earned or retirement income. At an entry-age annual cost of 41.7 percent of payroll, military retirement is, by far, the most costly of the three retirement systems. In addition, the military retiree will become fully entitled to social security payments, which, when added to the military retirement costs, boost the overall cost to 55 percent of covered payroll. Civil service retirement does not cost so much as military retirement, but the cost is higher than most private sector counterparts. The 32.2 entry-age annual cost is due to initial benefit amounts that are comparable to the private sector, plus retirement at age 55 with unreduced and indexed benefits. Some 80 percent of civil service retirees eventually qualify for social security cash payments, thus increasing the overall Federal cost of their retirement income, although provisions of Public Law 98–21, the Social Security Amendments of 1983, have eliminated some of what previously had been a "windfall" benefit.

Advance funded cost estimates show the difference between the current pay-as-you-go approach and the amount that would be required if current unfunded liabilities were amortized over 40 years (ERISA requires that unfunded liabilities for private sector plans be amortized in between 30 to 40 years, depending on the plan) and if the normal cost were paid for those workers currently earning retirement credits. Proposals to "privatize" social security (make it voluntary or replace it with mandatory private plans) or to dismantle railroad retirement (as proposed by the administration in the fiscal year 1983 budget) would face the dilemma of how to amortize this cost.

The longrun trend in pay-as-you-go program costs (as a percent of payroll) demonstrates the change in the relationship between retirement benefit costs and payroll costs over the period. (See table 4.) Social security costs stay constant, even declining somewhat, until 2010, when the baby boom generation starts retiring. Military retirement and civil service retirement are higher, but relatively constant because the assumption was made that their current level of employees would be maintained during the entire period. The eventual decline in military retirement costs will occur after the retirees from the peak years of World War II, the Korean war, and the Vietnam war leave the rolls.

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[3] Military retirement is based on "basic pay," not total compensation. Social security does not base benefits on total pay but has a cap.

Table 4.—LONGRUN COSTS OF THE THREE LARGEST WORK-RELATED CASH ENTITLEMENT PROGRAMS—INTERGOVERNMENTAL METHODOLOGY

[Percent of payroll]

Year	Social security		Current CSRS		Military retirement	
	II-B	III	II-B	III	II-B	III
1983	11.2	11.7	34.3	34.6	52.6	52.6
1990	11.0	11.3	36.9	37.7	52.3	53.3
2000	10.1	11.5	37.8	39.5	53.7	56.3
2010	10.4	12.4	37.3	39.8	53.0	56.7
2020	14.3	18.3	37.5	40.5	51.0	55.1
2050	15.4	24.5	36.4	39.3	51.5	55.7

Source: Estimates are from agency actuaries, CRS model, and Hay Huggins using social security II-B and III assumptions for 1984. They are calculated as percent of payroll with intergovernmental or pay-as-you-go financing.

Financing Issues in the Long Run

Longrun financing issues differ from program to program, and these are discussed briefly in part III of this report. Even if agreement can be reached on what constitutes a longrun financial problem in a pay-as-you-go entitlement program, making longrun program reforms in the absence of trust fund tabulations is difficult unless accompanied by the pressures of budget priorities. However, current proposals to freeze social security COLA's are not necessary for longrun actuarial balance.

Civil service retirement and military retirement have no trust fund shortages looming in the long run. If these two systems can be said to have longrun financing problems, it is because they are perceived as too generous compared to private sector counterparts.

Table 5 shows social security's longrun cost compared to the current law tax rate. It indicates a substantial surplus using social security's optimistic assumptions, longrun balance between income and outgo under the II-B assumptions, and a longrun deficit under the III assumptions. Using the more pessimistic III assumptions, the trust fund deficit alone during 2032 to 2056—the final 25 years of the 75-year valuation period—would be greater than the current tax rate on individual workers. In order to pay benefits for that 25-year period, social security's current tax rate would have to be raised 80 percent for that 25-year period.

Even with the II-B assumptions, which show financial balance over the 75-year period, the average deficit during the final 25-year period would be 2.14 percent, or 17 percent of the current law tax rate.

In the long run, differences in demographic conditions affect overall costs much more than in the short run, and combine with

differences in economic assumptions to show dramatic longrun differences, especially in social security. For example, the longrun average cost with III assumptions is 33 percent higher for social security than with II-B assumptions. This difference shrinks to 6 percent for civil service and military retirement. Social security varies much more with the changes in demographic assumptions because virtually the entire population is affected. Thus, it shows a large additional system cost when the large baby boom generation retires.

Table 5.—LONGRUN OUTLOOK FOR SOCIAL SECURITY SURPLUSES/ DEFICITS

PAY-AS-YOU-GO FUNDING

[Percent of payroll]

	I	II-B	III
25-year averages:			
1984–2008	3.15	2.01	.97
2009–2033	2.69	−.05	−3.36
2034–2058	2.40	−2.14	−9.98
75-year averages:			
1984–2058	2.75	−.06	−4.12

Source: 1984 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

LONGRUN COSTS AS A PERCENT OF GNP

The traditional way to express longrun costs for social insurance and pension programs has been as a percent of payroll. Other ways of measuring these costs can be used to consider the programs as competing for the limited resources with other national needs. Estimated future costs can be expressed as a percentage of the gross national product (GNP). The advantage of the GNP measure is to show what proportion of total national income will be needed to pay benefits to persons who are no longer expected to work and who are covered by work-related entitlements. Some see a disadvantage in expressing future cost estimates in this way because it breaks the close tie between the costs of an individual pension system and the total pay earned in that organization.

The GNP measure of program costs offers insights into the longrun prospects of work-related entitlement programs relative to the total economy needed to support them. As shown in table 6, expenditures of three of the work-related entitlement programs, social security, civil service, and military retirement, are projected at 5.9 percent of GNP in 1985. This ratio decreases to 5.8 percent in 1990 and thereafter continues to decrease for a time, reaching 5.1 percent in 2005. Starting in 2015, the ratio increases because of the retirement of the baby boom. These expenditures as a proportion of GNP reach a high point of 6.5 percent in 2025.

Table 6.—PROJECTED COST OF THREE LARGEST WORK-RELATED CASH ENTITLEMENT PROGRAMS

PAY-AS-YOU-GO FUNDING—INTERGOVERNMENTAL

[As percent of GNP]

Year	Assumptions II-B
1985	5.9
1990	5.8
1995	5.6
2000	5.2
2005	5.1
2010	5.2
2015	5.6
2025	6.5
2050	6.4

Source: Offices of the Actuary of the Social Security Administration, Department of Defense, and the Congressional Research Service. To insure completeness and consistency, needed modifications of the data were made by Hay Huggins, 1984.

Chapter 7

EVALUATING ENTITLEMENT BENEFITS: MEASURING ADEQUACY AND EQUITY

The increases in costs of work-related entitlement programs are of pressing importance at this time. But equal consideration should be given to the equity and adequacy of benefits of these entitlement programs. To build and hold public support for work-related entitlement programs, and the taxation needed to fund them, it is crucial that benefits generally be perceived as fair.

As noted, the benefits provided by social insurance and public pension programs have been steadily increasing in dollar amounts and can be expected to continue increasing in the future. Since incomes and prices also have been and are expected to continue increasing, some standards other than absolute dollar amounts are needed to evaluate the benefits provided by the programs under review. These issues and standards are discussed below.

Retirees are not a homogeneous group. Their differences complicate applications of equity and adequacy standards. At least three distinctions among persons age 65 or older deserve special attention.

First, women, on average, live longer than men, and thus the ratio of women to men increases with advancing age. Since the population as a whole is increasing in age, retirement issues are increasingly likely to focus on income deficiencies some women face in their later years.

Second, there are wide variations in both the levels of retirement incomes and in the sources of those incomes. Among persons age 65 or older, for example: black people have lower incomes and fewer sources of income than white persons, women are less favored in both respects than men, persons over age 75 are less favored than persons age 65 to 74, and single persons are less favored than married persons. These variations mean that aggregate data on persons age 65 or over measuring incidence of poverty may obscure severe problems confronting some retirees.[1]

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[1] Sources and amounts of income of persons age 65 or older are discussed in more detail in appendix A, p. 457, "Financing Work-Related Entitlement Programs." April 1983, Committee Print, U.S. Senate Committee on the Budget.

Labor force participation among persons age 65 or older has declined over the past 50 years. Although some data suggest that this decline has abated, a definitive pattern has not emerged. The work decline of older people means that more people are dependent on their retirement income at earlier ages. Public and private provisions for retirement incomes have become, therefore, an increasingly important issue. Adequacy and equity of the benefits provided by work-related entitlement programs in the long run are important in evaluating the financial performance of these programs.

Third, evaluation of benefit adequacy must take into account the somewhat different purposes of social insurance and pension programs. Social insurance programs are intended to partially replace earnings lost when a covered worker retires, becomes disabled, or dies. Most workers, especially those who worked at higher wages, will supplement their social insurance benefits with private resources. Social insurance benefits are intended only to provide a floor of protection or a reasonably satisfactory minimum standard of living for the great majority of recipients.

In contrast, the pension programs in this analysis reflect a variety of organizational objectives. As staff retirement pension plans, they are designed to help recruit career-oriented workers, to retain current workers through the peak of their productive years, to keep appointment and promotion opportunities open, to ease adjustments in the size and composition of the work force, and to provide an adequate income in retirement. As a result, pension benefits provided by these plans tend to be more substantial than social insurance benefits.

Equity of Program Benefits

Program equity, as a concept, is often considered in tax policy and in analyzing such programs as welfare and social security. While equity has been less often applied to Federal pension programs, it is relevant to this study. Equity requires that individuals in similar circumstances be treated the same. However, another equity measure is sometimes applied to social security: the rate of return one can expect if his contributions are treated as investments. In the case of social security, this is sometimes phrased as getting one's "money's worth."

Criticisms of inequity are often made of social security. Individuals in equal circumstances are not always treated equally. Without getting into technical definitions of equity, some of the features of the programs that have led to claims of inequity are discussed below.

The current "tilt" in the social security formula gives a greater yield per payroll tax dollar to low earners. Moreover, a worker with a dependent spouse receives 50 percent more in benefits than a single individual does, even if they both have exactly the same earnings record and thus have paid exactly the same amount of taxes. An even more important consideration than whether or not these features represent "inequitable" treatment is whether or not they should be changed if they do. These features were designed to

meet certain social adequacy goals of the Nation's major social insurance program; to change them would reduce the benefits to the lower income sector of the population, and to dependent spouses—often women with little or no work history.

The issues surrounding the rate of return or "money's worth" argument are equally controversial.[2] Any analysis of this question will rest heavily on whether or not the employers' contributions are counted along with the employee's contributions and on the proper interest rate used to assess the value of contributions. In general, it can be said that for all retirees to date, the rate of return has been very high, even when they have paid payroll taxes for a number of years. The average earner retiring in 1985 who has contributed from the beginning of the program will receive back in benefits the value of his contributions, with interest and including employer payments, in about 7 years.

For the future, however, the picture clouds. Whether workers will receive their money's worth in the future will depend on their level of earnings, presence of a dependent spouse, and the extent of economic growth in the country as a whole. Moreover, some would argue that such individual comparisons are irrelevant since the system is a social insurance program that has societal objectives rather than merely individualistic ones. It should be noted that the recent action taken to reduce the longrun social security financing deficit, by cutting benefits and increasing payroll taxes, has reduced the expected rate of return.

Although this discussion of rate of return has focused on social security, the same issues are raised for any defined benefit plan.

Equity issues in pension programs have been raised by some who claim that insufficient benefits go to low-income individuals and to women. In general, the combination of pension programs and social security provide reasonably high replacement rates for those with a long, steady work history. As noted, social security was not intended to provide all retirement income and retired workers who received only social security may receive relatively low replacement rates. Until recently, women and low-income individuals have had difficulty in attaining either a long or steady work history. The civil service retirement program, in particular, handsomely rewards those who stay through a full career with the Federal Government. Those who leave early are faced with the choice of withdrawing their own contributions, only a fraction of the value of benefits earned if they stayed in, or having their earned retirement credits severely eroded by inflation until the age of eligibility arrives.

Benefit Adequacy

The replacement rate—the ratio of program benefits to preretirement earnings—is often used as a measure of benefit adequacy. The numerator of the replacement rate is usually some measure of

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[2] Chapter III of the April 1983 "Financing Work-Related Entitlement Programs" includes a comprehensive analysis of the "money's worth" issue.

a worker's (family's) income after retirement, and the denominator is some measure of the worker's (family's) earnings before retirement (using the earnings in the year before retirement).

Because of the great diversity in earnings patterns over individual lifetimes, specifications of the denominator must reflect a measure of "well-offness" consistent with the intent of the system. Because earnings are often erratic during the final work years, and because the final year may be atypical, an average of a few years of earnings preceding retirement is sometimes used as a measure of preretirement earnings (such as an average of the highest 3 or 5 consecutive years of earnings). Because lifetime earnings streams differ markedly between individuals, preretirement earnings are not representative of lifetime earnings positions. Thus, if a lifetime concept of the replacement base is desired, earnings must be appropriately averaged over many years.

A number of researchers have made estimates of the replacement rates necessary to maintain living standards in retirement. Most agree that retirees need less than 100 percent of their gross earnings replaced to maintain their standard of living. While no precise earnings replacement objectives have been established as a matter of national policy, some studies would suggest that individuals need between 50 and 80 percent of gross preretirement earnings to maintain preretirement living standards—with rates at the higher level more appropriate for lower income individuals.

President Carter's Commission on Pension Policy estimated the percentage of gross preretirement income that would need to be replaced for workers at different income levels to maintain their preretirement standard of living. After making adjustments for changes in tax liability, work-related expenses, savings, and investments, the Commission estimated that replacement rates ranging from 51 percent to 86 percent would provide retirees the same standard of living as before retirement in 1980. As shown in table 1, needed replacement rates vary depending upon income and living arrangements.

Table 1.—GROSS RETIREMENT INCOME REPLACEMENT RATE NEEDED TO MAINTAIN PRERETIREMENT STANDARD OF LIVING—1980

[In percent]

Gross preretirement income	Single person	Married person
$6,500	79	86
$10,000	73	78
$15,000	66	71
$20,000	61	66
$30,000	58	60
$50,000	51	55

Source: U.S. President's Commission on Pension Policy. "Coming of Age: Toward a National Retirement Income Policy." Feb. 26, 1981. Washington, 1981. pp. 42–43.

The Commission estimates indicate that a 7- to 9-percent increase in retirement income is needed to cover the difference in expenses between single and married households. The choice of survivor annuities, however, in the current CSRS actually reduces the retirement income replacement rate, while social security benefits, on the other hand, are increased by 50 percent for married couples. As a result, employees covered by a private pension plan integrated with social security receive more if married than if single.

Net earnings replacement rates permit a better comparison between pre- and post-retirement income. Differences in tax liability before and after retirement and reduction of work-related expenses such as social security payroll tax deductions, transportation, clothing, and meals purchased away from home are taken into consideration. In addition, differences in discretionary consumption and savings, and possible reductions in living expenses in later life (resulting from lower home financing, educational expenses for children, etc.), influence living standards.

The following table provides net replacement rates for hypothetical workers receiving benefits from different pension systems. Since tax treatment varies substantially before and after age 65, replacement rates are shown after taxes. This approach is compatible with the discussions of the President's Commission on Pension Policy. Replacement rates were calculated for both a "low income" worker (final salary of $15,000 in 1984 dollars) and a high-income worker (final salary of $65,000). Since social security has provisions for dependent spouses, replacement rates are shown for both single workers and workers with dependent spouses. These rates are for the year immediately after retirement and for the same workers 15 years later at age 80. The extent of cost-of-living indexation of benefits and tax treatment varies from program to program. Without cost-of-living protection, the value of benefits in real terms declines. These examples assume workers with work histories of 40 years who retire and receive benefis at age 65, as well as those who retire at age 55 with 30 years of work.

When the replacement rates are higher than 100 percent, the after-tax income of the retiree is actually greater than before retirement. Social security by itself does not reach the 100 percent level although it comes close for low-income workers with a spouse. This underscores the notion that social security should not be looked upon as the sole source of retirement income. And, indeed, of families with a person over age 65, only 12.3 percent show income from social security as the only source. On the other hand, for 31 percent of families with a person age 65 or older, social security is 50 percent or more of their income. Social security represents 50 percent or more of income for 57 percent of single individuals age 65 or older.

As table 2 shows, civil service retirement, military retirement, and the combination of social security plus private pension, yield very high net replacement rates for individuals with long, consistent work histories.

Table 2.—AFTER TAX REPLACEMENT RATES (AGE 65 WITH 40 YEARS OF WORK)

	Low earner		High earner	
	Single	Married	Single	Married
Civil service retirement (no social security)	91.7	82.2	110.5	93.5
Military retirement plus social security	103.0	128.3	96.2	96.5
Social security plus private pension	94.8	111.5	78.1	80.9
Social security plus private pension and a capital accumulation plan	169.4	175.7	141.0	132.1

Note.—These calculations are based on a common set of work histories and earnings records. They were patterned after salaries of Federal workers. The low-income worker had a final salary of $15,000 and the high earner a final salary of $65,000. Civil service retirement benefits are not taxed until the amount of employee contributions has been paid back. Ordinarily this occurs after 1 or 2 years. Thus, replacement rates shown here are higher than they would be 1 or 2 years hence.

Source: Congressional Research Service, 1984.

In general, the programs considered in this analysis provide after-tax income replacement at a level fairly close to the level of income before retirement whether high or low except for retirement workers receiving only social security. Except for civil service retirement, the programs shown in table 2 all include a combination of social security and another type of pension. Married couples received substantially higher replacement rates as a result of social security's provision of benefits to dependent spouses based solely on the earnings record of the working spouse.

The effect of social security is also seen in the difference between high- and low-income workers. Social security's benefit formula "tilt" shows up as higher income replacement in the low-income workers, except for civil service retirement which has no social security component. High-income earners under civil service retirement actually receive higher income replacement than do low-income workers in the first 1 or 2 years of retirement because the difference in tax treatment makes a bigger difference between preretirement and postretirement earnings. After the first 1 or 2 years, the situation is often reversed.

Of the examples considered here, military retirees and civil service retirees have their benefits fully indexed to changes in the cost of living. Thus, 15 years after retirement, their pretax benefits will have maintained the same relationship to preretirement earnings that they had upon retirement. (See table 3.) For private sector employees, however, only the social security component is fully indexed. Private pensions are rarely fully indexed, and thus over time the size of the pretax retirement benefit in relation to the preretirement income shrinks. This reduction would amount to about 23 percent in 15 years for high-income private pension beneficiaries. For lower income recipients, whose overall benefits include a relatively larger social security component, the shrinkage is less, about 15 percent for private pensions. Military retirees and civil

service retirees suffer no diminution at all, since their benefits are fully indexed. The replacement rates for civil service retirement, however, do differ at ages 65 and 80. Civil service retirement benefits are taxable but are not taxed until the amount of employee contributions has been paid back, ordinarily a period of 1 or 2 years. Thus replacement rates shown are higher at age 65 than at age 80.

Table 3.—AFTER-TAX REPLACEMENT RATES (SINGLE-WORKER)

	At age 65		At age 80	
	Low earner	Higher earner	Low earner	Higher earner
Civil service retirement (no social security)	91.7	110.5	88.9	87.6
Military retirement plus social security	103.0	96.2	103.0	96.2
Social security plus private pension	94.8	78.1	80.3	60.0
Social security plus private pension and a capital accumulation plan	169.4	141.0	123.7	98.4

Source: Congressional Research Service. See note on table 2.

The difference in early retirement provisions is highlighted in table 4. Civil service retirement and military retirement, both of which allow early retirement with unreduced benefits, show high replacement rates even with early retirement. (The hypothetical private pension plan included in these examples for comparison purposes permitted retirement at age 55, but with substantially reduced benefits. Since social security benefits do not start until at least age 62, at age 55 this shows only the effect of the private pension.) By age 80, the private pension and military retirement recipients have begun receiving social security in addition to their other pensions, thus boosting their overall replacement rates.

Table 4.—AFTER-TAX REPLACEMENT RATES (AGE 55 WITH 30 YEARS OF WORK)

	Age 55		Age 80	
	Low earner	Higher earner	Low earner	Higher earner
Civil service retirement (no social security)	67.4	81.1	67.4	67.1
Military retirement plus social security	64.1	72.1	117.1	105.5
Social security plus private pension	22.9	30.9	40.2	29.2
Social security plus private pension and a capital accumulation plan	67.4	75.7	60.9	47.6

Source: Congressional Research Service. See note on table 2.

Value of Benefits

Over a lifetime of work, an individual accrues rights to a stream of benefits to be received upon retirement and continuing until death. This stream of benefits can be thought of as an asset whose value can be calculated. The asset value is the sum of the present value of the future stream of benefits, plus the compounded value of benefits already received from programs permitting early retirement with unreduced benefits.

Table 5 displays these asset values for workers retiring at age 65 with 40 years of work and a final income of about $30,000 in 1984 dollars. (The values are shown graphically in figure 1.) Considering only future pension benefits at age 65, the value of these benefits varies substantially for civil service retirement, military retirement, and private pension plus social security—between $278,000 and $345,000. These exceed social security alone, which is $123,000—driving home the point once again that social security should not be thought of as sufficient retirement income by itself.

Figure 1

VALUE OF BENEFIT AT AGE 65

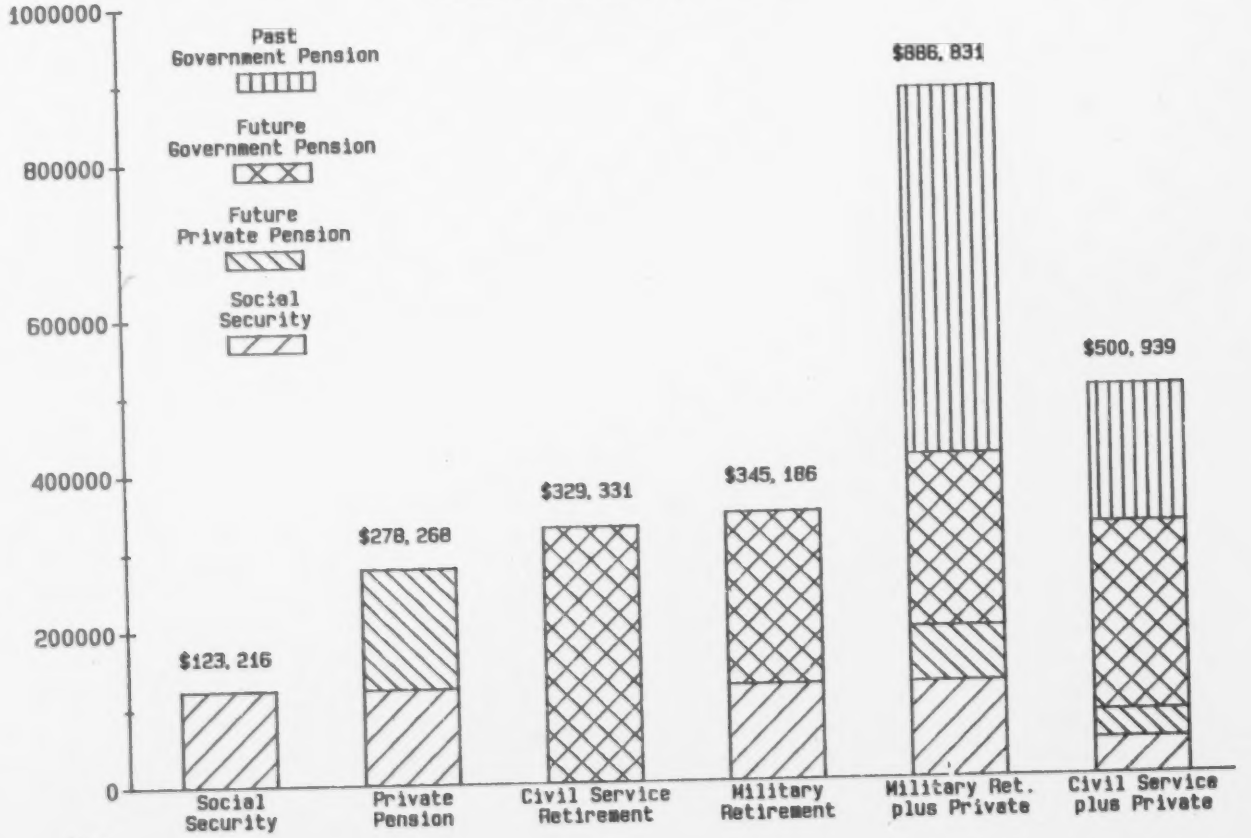

Table 5.—VALUE BENEFITS AT AGE 65 (AFTER 40 YEARS OF WORK ON FINAL EARNINGS OF $30,000)

Social security	123,216
Private pension system:	
Social security	123,216
Pension	155,052
Total	278,268
Civil service retirement at age 65	329,331
Military retirement at age 65:	
Social security	123,216
Military pension	221,970
Total	345,186
Military retirement (20 years military + 20 years private):	
Social security	123,216
Private pension	70,800
Military pension (future)	221,970
Military pension (past)	470,845
Total	886,831
Civil service retirement (30 years +10 years private):	
Social security	46,659
Private pension	35,400
CSRS (future)	242,808
CSRS (past)	176,072
Total	500,939

Note.—The values for private pension do not include a voluntary capital accumulation plan.

Source: Hay Huggins, 1984.

The variation in total program benefits is seen most dramatically for programs permitting early retirement benefits. For the military retiree, benefits have been received for 20 years, compounding to yield an amount which, when combined with the future annuity amounts of military retirement plus social security and a private pension, is almost $887,000. Early retirement benefits in civil service retirement are added to future annuities in the same way, except that it would only be for 10 years. The combination of compounded payments to age 65 together with the present value of future benefits would total approximately $501,000 for civil service. These past benefit payments add greatly to the overall asset values as well as program costs. This explains in part why these two programs are more expensive, as a percent of payroll, than most private sector counterparts.

Part III

Current Financial Status of Work-Related Entitlements: Program Descriptions, Recent Legislation, and Proposed Reforms

Chapter 1

MEDICARE

(By JANET KLINE) [1]

Introduction

Medicare is a two-part program that provides hospital and medical insurance for older people, certain disabled persons, and those who suffer from end-stage renal disease. About 30 million people will be covered under both parts of medicare in fiscal year 1985. (See table 1.) Medicare's hospital insurance (HI) program, also known as part A, helps to pay the costs of inpatient hospital services, skilled nursing facility services, home health care, and beginning in November 1983, hospice services. The hospice program is a temporary benefit which will expire on October 1, 1986.

The supplementary medical insurance (SMI) program, or part B, helps pay for the services of physicians, outpatient hospital care, laboratory and other diagnostic tests, certain chiropractic, podiatric, and dental services; x-ray and radiation therapy; home dialysis supplies and equipment; physical and speech therapy; as well as certain other services. Approximately 7.7 million persons will receive services under the HI portion of medicare in fiscal year 1985, while about 21.1 million beneficiaries will receive supplementary medical services.

Medicare now accounts for more than a quarter of national health spending for hospital care and nearly one-fifth of all health care spending for physician services. Between 1980 and 1983, medicare outlays grew at an average annual rate of 18 percent. During fiscal year 1985, medicare outlays are estimated to reach $76.8 billion, up from $35.0 billion in 1980. The rapid growth in medicare has been dramatic and persistent. Factors underlying these increases include increases in the numbers of persons protected by the medicare program (for example, the disabled) and increases in the quantities and composition of the health services provided to program beneficiaries. But most of the growth is the result of persistent inflation in the health care industry and in the economy as a whole. In recent Congresses, most of the legislation enacted to amend the program has been designed to stem this extraordinary rate of growth.

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[1] This chapter is drawn from various Congressional Research Service issue briefs and reports prepared by analysts in the Health Section, Education and Public Welfare Division.

Table 1.—HOSPITAL INSURANCE AND SUPPLEMENTARY MEDICAL INSURANCE PROGRAM DATA [1]

	Fiscal years		
	1983 (estimate)	1984 (estimate)	1985 (estimate)
PERSONS ENTITLED OR ENROLLED (IN MILLIONS) [2]			
HI	29.1	29.7	30.2
Aged	26.2	26.8	27.3
Disabled	2.9	2.9	2.9
SMI	28.7	29.2	29.8
Aged	26.0	26.6	27.2
Disabled	2.7	2.6	2.6
PERSONS RECEIVING SERVICES (IN MILLIONS) [2]			
HI	7.3	7.5	7.7
Aged	6.5	6.7	7.0
Disabled	0.8	0.8	0.8
SMI	19.6	20.3	21.1
Aged	17.8	18.5	19.2
Disabled	1.8	1.8	1.8
BENEFIT OUTLAYS (IN BILLIONS OF DOLLARS) [3]			
Total	56.9	66.3	76.8
HI	38.6	45.1	52.1
SMI	18.3	21.3	24.7

[1] Numbers may not add due to rounding.
[2] Source: Health Care Financing Administration.
[3] Source: President's Fiscal Year 1985 Budget.

Medicare requires patients to share the costs of inpatient hospital services and skilled nursing facility services, certain hospice services, as well as physician and related medical services through a series of statutorily determined deductibles and coinsurance payments. In 1985, the medicare inpatient hospital deductible will total $400 per benefit period.[2] During each benefit period, in 1985, the following coinsurance amounts will apply:

[2] A benefit period begins the first time a beneficiary enters a hospital after HI coverage begins. It ends after he or she has not been an inpatient in a hospital or skilled nursing facility for 60 consecutive days. There is no limit on the number of benefit periods a beneficiary may have.

Inpatient hospital services:
—$0 day 1 through 60
—$100 daily day 61 through 90
—$200 for each lifetime reserve day [3]

Skilled nursing facility care:
—$0 day 1 through 20
—$50 daily day 21 through day 100

Hospice care: [4]
—outpatient drugs: 5 percent of drug costs, not to exceed $5 per prescription
—respite care: 5 percent of the reasonable cost of respite care as estimated by the hospice (not to exceed the medicare inpatient hospital deductible)

Beneficiaries receiving supplementary medical services are subject to an annual $75 deductible. Once the deductible is met, beneficiaries are responsible for 20 percent of the "reasonable charge" (as determined under program regulations) for the services; medicare will pay 80 percent of the "reasonable charge." The coinsurance and deductible do not apply to home health services received under part B.

Program Financing

The HI program is financed primarily from amounts appropriated to the hospital insurance trust fund under permanent appropriation of taxes paid by workers and their employers, and by individuals with self-employment income, in work covered by the hospital insurance payroll tax. In general, covered employment is the same as that covered by the social security (OASDI) and railroad retirement cash benefit programs. Beginning in 1983, all Federal Government employment, with very minor exceptions, is also covered by, and subject to payroll tax under hospital insurance. (The Social Security Amendments of 1983 also require Federal employees hired after January 1, 1984, to be covered by social security (OASDI), but most of the current Federal work force remains outside the OASDI system.) An individual's HI contributions are computed as a percent of annual wages or self-employment income, or both combined, up to a specific maximum annual amount.

Beginning in 1985, the maximum taxable earnings amount is adjusted automatically by law each year to reflect changes in the general level of wages in employment subject to social security taxes, including the HI tax.

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[3] A lifetime reserve of 60 hospital days may be drawn upon when more than 90 days per benefit period are needed.

[4] Medicare will temporarily cover hospice care for beneficiaries having a life expectancy of 6 months or less. This benefit is effective November 1, 1983, and expires October 1, 1986. Part A beneficiaries may elect to receive hospice care in lieu of most other medicare benefits for up to two periods of 90 days each, plus an additional 30 days.

Table 2.—HOSPITAL INSURANCE TAX RATES AND MAXIMUM TAXABLE AMOUNT OF ANNUAL EARNINGS

Calendar year	Maximum taxable earnings	HI tax rate (percent) [1]	Maximum HI contribution
1981	$29,700	1.30	$386.10
1982	32,400	1.30	421.20
1983	35,700	1.30	464.10
1984	37,800	1.30	491.40
1985	39,600	1.35	534.60
Scheduled future rates:			
1986 or later	(2)	1.45	(2)

[1] Rates on employee (and self-employed individuals) and employer each as a percentage of taxable earnings (payroll). Beginning in 1984, the rate on self-employed persons is double the employee/employer rate.
[2] Changes automatically by law each year.

In general, the principles employed in financing the HI program are similar to those employed in the social security cash benefit programs. That is, the HI program is designed to be supported by the HI taxes paid by insured persons and employers. This financing also includes interest earnings and any net investment gains from assets available in the HI trust fund. The only exceptions to these principles are made in connection with coverage of a small number of uninsured individuals and voluntarily enrolled persons covered under the program; their costs are financed from general revenues and from premiums.

The supplementary medical insurance (SMI) program is financed by monthly enrollee premiums, which are currently $15.50 per month, and appropriations from general revenues of the Treasury. The original medicare legislation required the Secretary of the Department of Health and Human Services (DHHS) to set the monthly premium amount so that aggregate premium income would equal one-half of SMI program expenses projected for the forthcoming year plus a contingency reserve to cover projection errors and unanticipated events. The remaining one-half of fund revenue was provided by appropriations from general revenues.

Legislation in 1972 limited increases in the part B monthly premium to the percentage increase in cash benefit payments under the old-age, survivors and disability insurance programs that has occurred since the last increase in the premium. Under the law, when the premium increase is insufficient to cover one-half of SMI program expenses, the difference is made up by additional appropriations of general revenues. Since then, program expenses have significantly out-paced increases in cash benefits so that, by 1983, premiums accounted for about 25 percent of total program revenues instead of the 50 percent originally envisioned. Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) and the Social Security Amendments of 1983 (Public Law 98-21) first temporarily suspended the earlier limitation on SMI premium increases for two 1-year periods and then delayed the sus-

pension for 6 months. The Deficit Reduction Act of 1984 extended the 2-year suspension for 2 additional years. Under current law, SMI premiums beginning in January 1984 will be allowed to increase to a level sufficient to produce premium income equal to 25 percent of projected SMI costs for aged enrollees. The earlier limitation on premium increases will again apply for periods beginning on or after January 1, 1988.

1983 Social Security Amendments

Before the passage of the Social Security Amendments of 1983 (Public Law 98-21), the medicare program reimbursed hospitals according to the "reasonable costs" incurred in providing services to medicare beneficiaries. Because the actual "reasonable costs" could not be determined until after the hospital had provided the services and reported its costs to the medicare program, this method of reimbursement became known as "retrospective cost-based reimbursement."

Critics of the retrospective cost-based method of hospital reimbursement argued that it provided few incentives for hospitals to be efficient or cost-conscious in their provision of care because the more they spent for medicare allowable costs, the more they were reimbursed. Rising medicare expenditures for hospital care led to interest by the Congress and the executive branch in placing limits on the amount to be reimbursed as well as altering the reimbursement methodology.

For a number of years, the DHHS has supported experiments and demonstration projects in certain States and localities to determine the advantages and disadvantages of making payments determined in advance of the provision of the hospital services. In that respect, 1972 amendments to the Social Security Act authorized DHHS to set prospective limits on costs that were recognized as reasonable by medicare. In addition, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 (Public Law 97-248) established a new 3-year ceiling (or target rate) on the allowable annual rate of increase in operating costs per case for medicare inpatient hospital services.

Despite these actions, concern over rising medicare hospital expenditures and projected HI trust fund deficits renewed efforts to change the medicare cost-based hospital reimbursement system. A provision in TEFRA required that DHHS develop legislative proposals for the prospective reimbursement of hospitals (and other providers) by medicare, to be reported to Congress by December 31, 1982. As a result, prospective payment legislation was introduced in Congress, amended, approved, and signed into law on April 20, 1983, as Title VI of Public Law 98-21, the Social Security Amendments of 1983. This new method of medicare payment for hospitals is effective for hospital cost reporting periods that begin on or after October 1, 1983.

The 1983 amendments established a prospective payment system under medicare. Under the plan, hospitals are reimbursed a set payment amount for each type of case. Cases are classified accord-

ing to the diagnosis related group (DRG) into which the case falls. The major features of the new plan follow.

Establishment of Payment Amounts.—National and regional payment rates are established for each hospital discharge. Separate payment rates are to apply to urban and rural areas in each of the nine census divisions of the country. The regional (i.e., census division) rates will no longer apply after the third year. Prospective rates are to be phased in over a 3-year period. In year one, 25 percent of the payment is to be based on regional DRG's and 75 percent on each hospital's own cost experience. In year two, 50 percent of the payment is to be based on a blend of national and regional DRG's (25 percent national, 75 percent regional) and 50 percent on each hospital's own cost experience. In year three, 75 percent of the payment is to be based on a blend of national and regional DRG's (50 percent national, 50 percent regional) and 25 percent on each hospital's own cost experience. In year four, payment is to be based on national DRG's.

Initial Payment.—Rates are to be derived from historical medicare cost data updated to fiscal year 1982 by the estimated industrywide increase in hospital costs (known as the "market-basket index"). In updating to fiscal year 1984, the market-basket index plus 1 percentage point is used.

Annual Updates.—For fiscal year 1985, the payment rates are to be increased by an amount equal to the market-basket index plus one-quarter of 1 percentage point. For fiscal year 1986 and for subsequent years, the Secretary will establish the rates of increase based on recommendations made by a commission of independent experts. However, in fiscal year 1986, the increase may not exceed market basket plus one-quarter of a percentage point.

Budget Neutrality.—The payment rates must be set so that aggregate payments to hospitals included in the payment system during Federal fiscal years 1984 and 1985 are neither more nor less than the aggregate amounts that would have been payable to these hospitals if the provisions of TEFRA had remained in effect.

Recalibration.—The Secretary will adjust the DRG rates in fiscal year 1986 and as necessary at least every 4 years thereafter to take into account changes in treatment patterns, technology, and other factors.

Atypical Cases.—Additional payments are required for cases which are extraordinarily costly to treat (based on cost and length-of-stay criteria) relative to other cases. Total payments for these unusual (known as outliers) cases may not be less than 5 percent or more than 6 percent of total medicare payments for inpatient care; the DRG payment rates per case are to be reduced proportionally to compensate for these "outlier" payments.

Capital Costs.—Capital costs are specifically excluded from the prospective payment system until October 1, 1986. A report is required by DHHS within 18 months of enactment (of Public Law 98–21) on how to bring these costs into the system. The current rate of

return on equity capital for proprietary hospitals is reduced but not eliminated prior to October 1, 1986. If a new system for reimbursing capital costs is not implemented by October 1, 1986, States will be required to institute planning programs for the approval of capital expenditures. Currently, the Secretary is authorized to exclude from reimbursement certain costs related to capital expenditures which have been disapproved under such programs.

Medical Education.—Direct medical education costs are to be reimbursed on the basis of "reasonable costs." The Secretary is required to provide specified payment adjustments in recognition of indirect costs associated with approved teaching activities.

Quality Review.—TEFRA required the Secretary to enter into contracts for utilization and quality control peer review with professional review organizations (PRO's) throughout the country. Until September 30, 1984, hospitals are required to contract with a PRO if there is one serving the geographic area; after that date they must contract with a PRO as a condition of receiving program payments.

State Programs.—For States which currently have medicare waivers to run their own cost control programs, medicare payments under the State system rather than the prospective system will continue provided certain conditions are met.

The 1983 social security amendments also included several additional medicare changes. It:

—Delayed the annual increase in the part B premium from July 1, 1983, to January 1, 1984, to coincide with the delay in the cost-of-living adjustment in social security cash benefit payments.

—Delayed implementation of a single reimbursement limit for skilled nursing facilities (SNF's) as authorized by TEFRA.

—Extended interfund borrowing among the OASI, DI, and HI trust funds through 1987. Repayment of over $12 billion that the HI trust fund loaned to OASDI in late 1982 is to be made during 1988–89 in 24 equal monthly payments. Beginning June 1983 and 1984, loans would be repayable when the fund ratio of the borrowing fund exceeds 15 percent.

Other Legislative Proposals Considered During 1983 and 1984

The President's budget was designed to reduce medicare outlays by $1.9 billion in fiscal year 1984. To achieve these reductions, the medicare budget centered around a number of legislative proposals, known as the health incentives reform program, which were submitted to Congress on February 28, 1983. The program's four major features included:

—A voluntary medicare voucher program to permit beneficiaries to receive services through private health benefits plans, including health maintenance organizations;

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—A proposal to restructure the current inpatient hospital and skilled nursing facility cost-sharing requirements in order to encourage greater cost consciousness among medicare patients;

—A temporary freeze on payments to physicians; an annual index on the part B deductible; and modification of the rate of increase in the part B premium; and

—A prospective payment system for medicare inpatient hospital services.

As noted above, a modified version of the administration's proposal for prospective payments to hospitals was approved by the Congress as a part of Public Law 98–21. Congress essentially rejected the administration's proposal to restructure and increase beneficiary cost-sharing amounts by specifying, as a part of the First Concurrent Resolution on the Budget, that medicare savings were not to be achieved through reductions in benefits or increases in beneficiary cost-sharing charges. The proposal to establish a voluntary voucher program received no action at all. Administration proposals to freeze physicians fees and make certain other part B changes were considered but no final action occurred during the first session. House and Senate reported bills (H.R. 4170 and S. 2032), among other things, included provisions to limit increases in the amounts medicare would pay physicians for covered services.

Currently, medicare pays for physicians' services on the basis of medicare-determined "reasonable charges." Any amounts in excess of "reasonable charges" are the responsibility of the patient except where a physician has agreed to accept "assignment."[5] Reasonable charges are the lesser of: a physician's actual charges, the customary charges made by an individual physician for specific services, or the prevailing level of charges for specific services in a geographic area. The amounts recognized by medicare as customary and prevailing charges are updated annually (on July 1) to reflect changes in physician charging practices. Increases in prevailing charge levels are further limited by an economic index which reflects changes in the operating expenses of physicians and in general earnings levels. The administration's fiscal year 1984 budget proposed that the annual increases in customary and prevailing charges not occur for the 1-year period beginning July 1983.

H.R. 4170, the Tax Reform Act of 1983, as reported by the House Ways and Means Committee, included a provision (which was not approved by the full committee) to roll back prevailing charge levels for physicians' services to hospital inpatients to the levels in effect in June 1983. H.R. 4170 would also have required physicians to accept assignment for such services (in other words, to accept medicare payment as payment in full for services rendered and agree not to hold patients liable for amounts in excess of the reasonable charge).

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[5] "Assignment" means that a physician accepts medicare determined reasonable charges as payment in full. With assignment the beneficiary's liability is limited to 20 percemt of reasonable charges.

H.R. 4136, the Medicare and Medicaid Budget Reconciliation Amendments of 1983, reported by the House Energy and Commerce Committee did not include a provision to freeze increases in physician charges fees or require mandatory assignment for hospital inpatient services. It did, however, require the Department of Health and Human Services to publish a list of physicians who agree to accept assignment for all the medicare patients for the next year. Both H.R. 4170 and H.R. 4136 included other medicare amendments, as well.

S. 2062, the Omnibus Reconciliation Act of 1983, as reported by the Senate Budget Committee, included a provision proposed by the Senate Finance Committee to authorize a rollback in prevailing charge levels for physician's fees to the level in effect in June 1983. The legislation also required the DHHS to prepare annual lists containing the complete names and addresses, assignment ratios, and volume of services of each physician; copies of the list were to be made available in appropriate locations, usually social security district offices. In addition, among other amendments to medicare, S. 2062 extended for 1 year the temporary statutory requirement which set the proportion of the part B medicare program costs financed by enrollee premiums at 25 percent. A similar amendment was proposed by the adminstration. However, the administration proposed to allow the preimum to increase so that by 1988, the part B premium would be set at a rate equal to 35 percent of program costs for the aged.

The Administration's Fiscal Year 1985 Budget

The administration's fiscal year 1985 budget proposed to reduce medicare outlays by $939 million in fiscal year 1985; it would have increased revenues to the medicare trust fund by $503 million in the same year. Many of the proposals initially included in the fiscal year 1984 budget remained a part of the fiscal year 1985 budget. However, the administration did not resubmit its proposal to restructure beneficiary cost sharing. Most of the fiscal year 1985 savings would have been achieved under two proposals: the proposal to freeze physician reimbursements for 1 year and a proposal to delay a beneficiary's initial eligibility to medicare by 1 month. Two proposals—one to gradually increase the part B premium and a second to limit tax-free employer-paid health benefits—accounted for the increased revenues to the trust funds. Similar revenue raising proposals were submitted as a part of the fiscal year 1984 budget. The major administration proposals follow:

—The administration proposed to maintain customary and prevailing charge levels for physicians beginning July 1, 1984, at the levels in effect for the year beginning July 1, 1983. This proposal was estimated to reduce outlays for fiscal year 1984 by $150 million and for fiscal year 1985 by $600 million.

—The fiscal year 1985 budget proposed to gradually increase the part B premium rate over a 6-year period beginning with calendar year 1985. The premium would rise 1⅔ percentage points each year so that by calendar year 1990, the rate

would equal 35 percent of estimated program costs. The administration estimated that this proposal would increase revenues to the trust fund by $296 million in fiscal year 1985.

—Under present law, eligibility for medicare begins on the first day of the month in which an individual reaches age 65. The administration budget proposed to delay eligibility for both parts A and B of medicare to the first day of the month following the individual's 65th birthday. It estimated that this proposal would reduce outlays for fiscal year 1985 by $265 million.

—Under current law, an employer's contribution to an employee's health plan is not included in the employee's gross income. As a result, such contributions are not subject to taxes, including social security and medicare taxes. The administration proposed to limit tax-free health benefits paid by an employer to $175 per month for a family plan and $70 per month for individual coverage. Employer contributions above these amounts would be included in the employee's income and taxed accordingly. Under the proposal, additional revenue would accrue to the part A trust fund through the imposition of the health insurance (HI) tax on newly taxable income. The earnings base is increased each year. The administration budget estimated that total Government revenues resulting from this proposal in fiscal year 1985 would be $3.9 billion. Of this, $207 million would accrue to the hospital insurance trust fund and an additional $873 million would accrue to the social security cash benefit trust funds.

The Deficit Reduction Act of 1984

On April 12, 1984, the House passed H.R. 5394, the Omnibus Reconciliation Act of 1984. This measure contained the majority of medicare provisions which were originally included in H.R. 4170 and H.R. 4136. The House, in its consideration of H.R. 5394, rejected the amendment that would have placed a freeze on physicians' fees for 1 year for services provided to hospital inpatients and would have required physicians to accept assignment for such services. As passed by the House, H.R. 5394 contained a number of savings reduction proposals as well as other medicare changes. Among others, it established fee schedules for clinical laboratory services, and required the Secretary of Health and Human Services to compile a list of physicians serving beneficiaries together with their assignment rates and a separate list of physicians who for the following year voluntarily agree to accept assignment in all cases.

On May 17, 1984, the Senate passed H.R. 4170, the Deficit Reduction Act of 1984. The medicare portion of the legislation was a modified version of the medicare provisions of S. 2062. The Senate passed bill included a number of provisions similar but not identical to those contained in H.R. 5394.

H.R. 4170 also contained a number of medicare provisions not contained in the House bill. It froze all physicians' fees for the 1-year period beginning July 1, 1984. The freeze would be continued

for the following year except for those physicians who agreed to become "participating," i.e., agree to accept assignment for all services for the year. The legislation made permanent the existing temporary provision which fixed the part B premium at 25 percent of program costs for the aged. It deferred program eligibility to the month following which, rather than during which, an individual reaches age 65. It provided for the indexing of the part B deductible (currently set at $75) in 1985–87.

H.R. 4170 also made several amendments to the prospective payment system. The major provision limited for fiscal year 1985 and fiscal year 1986 the annual rate of increase in the hospital cost portion of the payment amounts to the marketbasket minus one-half percentage point. For the DRG portion, the payment increase would be the marketbasket plus one-half percentage point. (Currently both are computed as marketbasket plus 1 percentage point.) The bill required the Secretary to study individual hospital wage indexes and make adjustments where appropriate. The bill also limited increases in capital-related cost reimbursement to a new owner that would result from revaluation of hospital assets acquired in fiscal year 1985 and thereafter.

On June 27, 1984, the House and Senate passed the conference report on H.R. 4170, the Deficit Reduction Act of 1984.

On July 18, 1984, the President signed Public Law 98–369 into law. The measure contains $6.1 billion reduction in medicare outlays over the fiscal year 1984–87 period. Key provisions of Public Law 98–369 follow:

—The act extended for 2 years (1987 and 1988) the provisions of TEFRA which permit the part B premium to increase to a level sufficient to produce program income equal to 25 percent of program costs.

—The act freezes medicare customary and prevailing fees for 15 months for all physicians beginning July 1, 1984. The legislation also establishes the concept of "participating physicians." A participating physician is one who voluntarily enters into an agreement with the Secretary to accept assignment for all services provided to all medicare patients. Participating physicians are subject to the 15-month freeze. However, they are permitted to increase billed charges during the freeze period; these increased charges will be reflected in their future customary fee screen updates.

—The act made a variety of modifications to the prospective payment system including setting the rate of increase in both the hospital specific portion and the Federal portion of the payment rates at a rate which could not exceed the marketbasket plus one-quarter percentage point in fiscal years 1985 and 1986.

—The act established a fee schedule for independent laboratories.

—The act limits increases in the capital-related cost reimbursement to a new owner of a hospital or a skilled nursing facility that would result from revaluation of assets to the lesser of historical costs (costs to the original owner) or the purchase price of the asset.

Medicare Advisory Council

The quadrennial Advisory Council on Social Security, appointed in 1982, was directed to focus its review solely on the medicare program. Because of the serious financial problems projected for the HI trust fund, the Council's recommendations mainly address the hospital insurance program. In its report, the Council acknowledged a probable deficit in the HI trust fund in 1995 ranging "between $200 and $300 billion, depending upon the optimistic or pesimistic view of the price changes in the medical industry and the economy generally in the next few years."

The Council offered 27 recommendations intended to: (1) provide a means for maintaining the fiscal integrity of the HI trust fund through 1995; and (2) to provide improvements in the manner in which health care is financed and delivered to alleviate some of the future financial pressures in the trust fund. The recommendations addressed issues of program financing, eligibility, benefit structure, and reimbursement, among others. The Council specifically opposed solving projected HI trust fund deficits by the increased use of general revenues or the addition of new payroll taxes.

Status of Hospital Insurance Trust Fund

The principles employed in financing the hospital insurance program are similar to those employed by the social security cash benefit programs. HI expenditures are intended to be sustained over the long run by the payroll taxes paid by workers and their employers (and the self-employed) into a hospital insurance trust fund. However, since its inception in 1965, the financial condition of the HI program has been unfavorable, in that the projected rate of increase of program costs has repeatedly exceeded the expected rate of increase of payroll tax revenues. In 1982 and 1983, Congress passed legislation to help reduce deficits in the HI program. However, unless further steps are taken to increase program revenues or reduce expenditures (or both), the HI trust fund could be exhausted in the 1990's.

Estimated operations of the HI trust fund over the next few years are shown in table 4. These projections suggest that total program income (including investment income) will generally continue to exceed outlays until 1987 but annual deficits will grow rapidly thereafter, reaching −$50.5 billion or almost 35 percent of annual expenditures in 1995.

Table 3.—ESTIMATED OPERATIONS OF THE HI TRUST FUND, CALENDAR YEARS 1984-95

[Dollars in billions]

Year	Income	Outgo	Borrowing [1]	Net increase in fund	Fund at year end	Assets [2] (percent)
1984	$46.3	$46.1		$0.2	$13.1	28
1985	52.5	52.7		−0.2	12.9	25
1986	60.3	58.7	$5.5	7.1	20.0	22
1987	65.1	65.5	6.9	6.6	26.6	31
1988	69.6	73.1		−3.5	23.1	36
1989	73.7	81.1		−7.4	15.7	28
1990	77.6	89.8		−12.2	3.5	17
1991	81.2	99.4		−18.2	−14.7	4
1992	84.7	109.2		−24.5	−39.2	−13
1993	88.1	120.2		−32.0	−71.2	−33
1994	91.4	132.2		−40.8	−112.0	−54
1995	94.7	145.1		−50.5	−162.5	−77

[1] The positive amounts shown for 1986 and 1987 represent repayment of a $12.4 billion loan from the HI trust fund to the old age and survivors insurance (OASI) trust fund in 1982.

[2] Fund assets (in dollars) at beginning of year as a percentage of estimated dollar outgo during year.

Source: 1984 annual report of the HI Board of Trustees and Office of Financial and Actuarial Analysis Health Care Financing Administration, Alternative II-B assumptions.

Note that the projections shown thus far reflect the effects of recent legislation as well as assumptions about future behavior where administrative discretion exists. For example, the projections taken from the April 1984 Hospital Insurance Trustees Report are based on the assumption that the Secretary of HHS will limit increases in the hospital payment rates under the medicare prospective payment system in fiscal year 1986 and later to the marketbasket rate (i.e., the rate of increase in the prices of goods and services hospitals purchase in the marketplace) plus 1 percentage point (see CRS IB83171 Prospective Payments to Medicare Inpatient Hospital Services).

However, these estimates preceded the passage of the Deficit Reduction Act of 1984 (Public Law 98-369) which limits the rate of increase in DRG prices to the marketbasket rate plus one-quarter of 1 percentage point in fiscal year 1985 and fiscal year 1986.

More recent CBO projections (August 1984) reflect the impact of the medicare provisions of the Deficit Reduction Act of 1984 as well as recent changes in hospital use and more favorable assumptions regarding the future performance of the general economy. These projections, shown in table 6, suggest that trust fund depletion may not occur until fiscal year 1994.

Table 4.—REVISED (AUGUST 1984) CBO BASELINE BUDGET PROJECTIONS OF HOSPITAL INSURANCE TRUST FUND INCOME, OUTLAYS AND BALANCES, FISCAL YEARS 1985–95

[In billions of dollars]

Fiscal years	Income	Outlays	Net increase in fund	Fund at yearend
1985	52	48	4	20
1986	61	53	8	29
1987	73	59	14	43
1988	72	66	6	49
1989	75	74	1	51
1990	79	82	−3	48
1991	85	92	−7	41
1992	91	103	−12	28
1993	97	116	−19	9
1994	102	130	−28	−18
1995	107	146	−39	−56

Source: CBO estimates, August 1984.

Both administration actuaries and CBO analysts provide a range of estimates regarding the future financial status of the HI trust fund. These additional estimates are intended to indicate the range of possible outcomes within which the actual experience is likely to fall and to provide some measure of the sensitivity of trust fund projections to changes in key economic assumptions. The most important assumptions concern the growth rate of real wages in the economy as a whole, the rate of increase in the prices associated with the diagnosis related groups (DRG's) in the medicare prospective payment system (PPS) after fiscal year 1986 (to be determined by the Secretary of Health and Human Services) and trends in the volume and mix of hospital use, including changes due to new technology, among medicare beneficiaries.

Using optimistic (high real wage growth, low PPS price increases) and pessimistic (low real wage growth, high PPS price increases) combinations of these assumptions, the trustees of the HI trust fund report trust fund depletion dates ranging from as early as 1989 to as late as 1995. The revised (August 1984) CBO estimates based on similar variations in assumptions suggest depletion dates as early as fiscal year 1992 or as late as fiscal year 1997 or fiscal year 1998.

Status of the Supplementary Medical Insurance Trust Fund

Unlike the hospital insurance program, there has been little discussion of problems with financing supplementary medical insurance even though SMI outlays are projected to increase at a faster rate than HI outlays. This is probably due, in part, because the SMI program is refinanced annually. Growth in program expenditures is almost simultaneously accommodated by increases in premium rates and by larger amounts of general revenues. No at-

tempt is made to estimate long range future outlays or the amount of premiums or general funds needed to meet program obligations.

The 1984 Annual Report of the Trustees of the Federal Supplementary Medical Insurance Trust Fund pronounced the fund actuarily sound. Despite this, the trustees noted with concern the rapid growth in the cost of the program and the extent to which general revenues have become the major source of financing for the program. While disbursements increased at an average annual rate of 20.9 percent from 1973 to 1983, general revenue contributions increased at an average annual rate of 24.2 percent during the same period. The trustees recommended that Congress take action to curtail the rapid growth in the supplementary medical insurance program.

General revenue contributions to the SMI fund during 1983 amounted to $14.2 billion, accounting for 74 percent of all SMI income. Premium and interest income accounted for about $4.9 billion. Of the $18.3 billion in SMI disbursements, $17.5 billion was for benefit payments while the remaining $0.8 billion was spent for administrative expenses.

Chapter 2

SOCIAL SECURITY

(By GEOFFREY KOLLMAN)

Introduction

The old-age, survivors and disability insurance (OASDI) programs—and the hospital insurance (HI) portion of medicare—are financed primarily by payroll taxes. Workers, their employers, and self-employed people covered by the program (about 90 percent of the work force) pay a flat-rate tax on their earnings up to a maximum amount. For 1985, the law requires employees and employers to pay OASDI taxes at a rate of 5.7 percent, each; and the self-employed, 11.4 percent, on earnings up to a maximum amount. The HI tax is 1.35 percent for employees and employers, each, and 2.7 percent for the self-employed. The maximum amount of earnings, called the contribution and benefit base because it is the maximum annual amount of earnings on which social security taxes are paid and which is creditable for benefits, increases each year in proportion to increases in average wage levels. The contribution and benefit base is $39,600 in 1985.

The tax rate is also scheduled to increase in the future. The table below shows the OASDI and HI tax rates for employees and employers, each, and the self-employed.

[In percent]

Calendar year	Employees and employers, each		Self-employed	
	OASDI	HI	OASDI	HI
1985	5.70	1.35	11.40	2.7
1986–87	5.70	1.45	11.40	2.9
1988–89	6.06	1.45	12.12	2.9
1990 on	6.20	1.45	12.40	2.9

In 1984, for the first time, the general fund paid part of the OASDI tax rate imposed on earnings of workers. Tax credits of 0.3

percent for employees and 2.7 percent for the self-employed offset part of the OASDI tax actually appropriated to the OASDI trust funds. Thus, wage earners actually paid 5.4 percent, and the self-employed paid 8.7 percent, of their earnings up to the contribution and benefit base in 1984. However, appropriations into the OASDI trust funds were based on tax rates of 5.7 percent for employees and 11.4 percent for the self-employed. The fiscal year 1985 budget estimates that these appropriations exceeded actual payroll tax revenue by $3,960 million in fiscal year 1984.

In 1985, employees are to pay the full tax rate of 5.7 percent, but the general fund will continue to pay part of the tax rate imposed on net earnings of the self-employed: 2.3 percent in 1985 and 2.0 percent in 1986–89.

Social security taxes go into the general fund of the Treasury and then are automatically appropriated to the old-age and survivors insurance trust fund and the disability insurance trust fund. All benefit payments and administrative expenses of the programs are paid from the appropriate trust funds. Payroll tax revenues in excess of benefit obligations are invested in special Federal securities. If benefit payments exceed payroll tax revenues in a given year, securities held by the trust funds are redeemed by the Treasury. The trust funds also receive payments from the general fund of the Treasury for expenditures that are believed to be financed more appropriately by general revenues and from the proceeds of taxing OASDI benefits.

Social security has been predominantly financed on a pay-as-you-go basis—contributions have been approximately equal to expenditures plus a small amount needed to maintain the trust funds. In other words, contributions paid by current workers are almost immediately paid out in current benefits. Today's workers, when they reach retirement age or become disabled, will receive most of their benefits from the contributions of the then-working population. Under pay-as-you-go financing, the primary role of the trust funds has been to serve as a contingency reserve to provide the funds necessary to pay benefits during temporary periods when income to the program is less than outgo.

Financial Status

Each year the Board of Trustees of the social security trust funds reports to the Congress on the current and future status of the funds. Financial projections are made in two ways:

—Short-range projections—from 1 to 10 years in the future—show estimated dollar flows into and out of the trust funds.

—Long-range projections—over the next 75 years—are expressed as a percentage of taxable payroll and compare the average annual income in the period to average annual expenditures.[1]

[1] The concept of expenditure as a percentage of taxable payroll is basic to an understanding of social security financing in the long range. Taxable payroll consists of the total earnings that

Continued

Because actual future income and expenditures are uncertain and depend on many variables, including fertility rates, mortality rates, economic conditions, etc., projections in the trustees' reports are based on four alternative sets of assumptions, ranging from pessimistic to optimistic. As noted earlier, alternative II–B is the set of assumptions generally used in making cost estimates and for describing the financial status of the program.

In evaluating the adequacy of projected revenues, two important measures are: (1) the "reserve ratio" and (2) the "actuarial balance." The reserve ratio, the principal measure of the adequacy of social security financing in the short range, is the ratio of the assets at the beginning of a year to the total expenses during the year. It shows the relationship between the funds on hand and the next year's commitments. Projected OASDI reserve ratios at the beginning of each of the next 8 calendar years are now expected to increase as a result of changes in program financing from the Social Security Amendments of 1983 (Public Law 98–21). Under the II–B assumptions, projected reserve ratios are:

	Percent
1985	21
1986	25
1987	27
1988	29
1989	41
1990	54
1991	69
1992	85

The actuarial balance compares average projected expenditures in the future (expressed as a fraction of a projected total taxable payroll) with projected revenues (also expressed as a fraction of taxable payroll). Under the intermediate set of assumptions used in the 1984 trustees' report, the projected actuarial balance for the next 75 years is minus 0.06 percent of payroll. Such a close relationship between trust fund outlays and revenues over time is considered to represent actuarial balance.

Recent Legislation

The Social Security Amendments of 1983

For the last several years projections of social security's financial status forecast insolvency for the system both in the long and short term. To solve OASDI's financing problems, President Reagan and congressional leaders formed a bipartisan panel, the National Commission on Social Security Reform. In January 1983, a majority of its members reached agreement on a compromise solution that was estimated to produce $168 billion in additional OASDI revenue and

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are subject to social security contributions. Expenditures expressed as a percentage of taxable payroll—expenditures divided by a taxable payroll shown as a percentage—can thus be compared to the combined employer-employee contributions rate schedule in the law. This concept is used because dollar figures become so large in the future with even moderate rates of inflation that the frame of reference is lost; i.e., the values expressed in dollar terms become virtually meaningless.

benefit reductions by the end of this decade and reduce the projected OASDI long-range deficit by two-thirds.

In March 1983, both Houses of Congress incorporated the Commission's recommendations, with some modifications, into major bills—H.R. 1900 and S. 1. Both bills also included provisions to resolve the remaining long-range deficit; H.R. 1900 was amended to raise the normal retirement age to 67 in the next century, whereas the Senate bill in the next century raised the retirement age to age 66 in conjunction with an across-the-board reduction in initial benefit levels. These different approaches, as well as other differences, were resolved in conference on March 24, 1983, and the bill was signed into law as Public Law 98–21 on April 20, 1983. The major provisions of Public Law 98–21 are as follows:

—Gradual increase in the age for eligibility for full retirement benefits to age 66 in 2009 and 67 in 2027;

—Coverage of Federal civilian employees hired after December 31, 1983, and most current executive level political appointees and elected officials (including Members of Congress, the President, and the Vice President) and Federal judges, effective January 1984;

—Compulsory coverage of employees of nonprofit organizations effective in January 1984 and a ban on the termination of coverage of nonprofit organizations and State and local government employment after 1982;

—Delay of the July 1983 social security cost-of-living adjustment (COLA) to January 1984 and a shift of future COLA's to a calendar-year basis (payable in January, rather than July, of each year);

—A "stabilizer" provision under which automatic annual benefit increases are to be based on the lower of price or wage increases if trust fund balances are low (less than 15 percent of outgo through 1988, 20 percent thereafter) and are to be readjusted upwards later to reflect full cost-of-living increases, if trust fund balances rise above 32 percent;

—Acceleration of scheduled increases for employees and employers, with an offsetting tax credit for employees for 1984; increase in the rates for the self-employed to equal the combined employee/employer rate but with partially offsetting credits and deductions;

—Inclusion of up to 50 percent of social security benefits in the taxable income of higher-income beneficiaries and transfer of projected revenues to the social security trust fund; and

—Additional provisions which eliminate "windfall" benefits for workers with pensions from noncovered employment, improvements in benefits for certain spouses, a lump-sum reimbursement to the trust funds for the cost of certain noncontributory military wage credits and for past unnegotiated checks, the crediting of tax receipts to the trust funds in ad-

vance of their actual receipts, and extension of borrowing among the trust funds to 1987.

The effect of the new law on OASDI financing is estimated to be $166.2 billion in increased revenue or benefit reductions in calendar years 1983–89 under the II–B assumptions. These changes under the 1984 trustees' report assumptions will be sufficient to assure the program's solvency in this decade, although the margin of safety, by historical standards, is fairly thin under the intermediate projections and very thin under the pessimistic projections. A severe recession may cause the solvency of the program again to be in question.

Under the II–B assumptions, the 1983 amendments also reduced the projected long-range OASDI deficit by 2.09 percent in payroll, to minus 0.06 percent of payroll. Thus, under these assumptions, the OASDI system is in close actuarial balance over the next 75 years.

Public Law 98–460

Over the past 3 years, many social security disability recipients have lost their benefits as a result of a major effort by the Social Security Administration (SSA) to reexamine their eligibility. This increase in reexaminations was required by amendments enacted in 1980, Public Law 96–265, as a congressional reaction to a decline in eligibility reviews during the 1970's. The Reagan administration implemented the new requirement in March 1981, ahead of schedule, in response to a General Accounting Office (GAO) report indicating that possibly 20 percent of existing disability beneficiaries were ineligible for benefits.

Concerns about the economic hardships caused by the loss of benefits and complaints that many of the terminations have been unfair led to legislation that would soften the impact of the new process.

In the House markup sessions on a draft bill were conducted in July, August, and September 1983, with the Ways and Means Committee reaching final agreement on an extensive package of changes on September 27, 1983. These measures originally were contained in H.R. 3755 (Pickle et al.). The committee subsequently incorporated them into an omnibus tax bill, H.R. 4170, which included numerous other changes in the tax law, medicare, and trade adjustment assistance. However, the recommended rule under which the House would have voted on the legislation was rejected on November 17, 1983, leaving the bill (including its disability provisions) in limbo at the time of congressional adjournment for the year.

Similar, but less costly, provisions were also presented to the Senate on November 17, 1983, when Senators Cohen and Levin et al. attempted to attach an amendment to H.R. 3959, another supplemental appropriations bill.

The key issue with the House disability package and the Cohen-Levin amendment, in addition to their cost, was over the question

of adopting a "medical improvement" standard. Advocates argued that it was needed to bring order to the system and relief from the harsh impact of the terminations. Critics argued that it would create a double standard between applicants and existing beneficiaries as well as allow ineligible recipients to remain on the rolls.

On March 14, 1984, the House Ways and Means Committee separated the disability provisions from the tax bill, and reported them out, this time by themselves, in H.R. 3755. The House subsequently passed them on March 27, 1984, by a vote of 410–1.

On May 18, 1984, the Senate Committee on Finance reported out related measures as contained in S. 476, introduced by Senators Cohen and Levin et al., with a number of modifications made by the committee. The Senate then passed them on May 22, 1984, by a vote of 96–0. By mid-September 1984 House and Senate conferees worked out an agreement on the legislation, which the House and Senate passed unanimously on September 19, 1984. President Reagan signed the bill into law (Public Law 98–460) on October 9, 1984.

The major provisions of Public Law 98–460 provide:

—That benefit payments be continued, with certain limitations, for those under review whose medical condition has not improved;

—Authority for continued benefit payments through the Administrative Law Judge decision in cases where a termination of benefits for medical reasons is being appealed (this authority expires on December 31, 1987);

—For a temporary delay of reviews of all mental impairment disabilities until regulations stipulating new medical listings for mental impairments are published;

—That in cases of multiple impairments, the combined effect of all the impairments must be considered in making disability determinations;

—That the Secretary initiate demonstration projects on providing face-to-face hearing between the beneficiary and State agency disability examiners in potential termination cases at the initial decision level;

—Temporary guidelines for the evaluation of pain as a disabling factor and directs that a study of the problem of pain be made by a commission to be appointed by the Secretary;

—Uniform standards, binding at all levels of adjudication, for disability determinations under Title II and SSI disability to be developed by regulation, subject to the Administrative Procedure Act;

—That closer evaluations of the qualifications of representative payees be required, and that the Secretary establish a system of annual accountability monitoring where benefit payments are made to someone other than a parent or

spouse living in the same household with the beneficiary; and

—That the Secretary federalize disability determinations in a State within 6 months of finding that a State is not in substantial compliance with Federal laws and standards.

SSA actuaries roughly estimate that these provisions will increase DI benefit payments by about $3.3 billion during the first 6 years following enactment.

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Chapter 3

CIVIL SERVICE RETIREMENT SYSTEM

(By DENNIS SNOOK)

Background

The current civil service retirement system (CSRS) is a staff retirement plan covering about 2.7 million Federal civilian employees, or 90 percent of the Federal civilian work force. Participation in CSRS is compulsory for most civilian employees of the Federal Government. The President, most members of the Federal Judiciary, and temporary or part-time workers are by law excluded from participation in CSRS, and participation is optional for Members of Congress and congressional staff. Also excluded from membership in CSRS are employees covered by other Federal retirement systems, such as the Federal Reserve Board retirement system and the Central Intelligence Agency retirement system.

Until recently, employees covered by CSRS were not covered by social security and did not pay taxes into the social security old-age and survivors insurance or disability insurance trust funds. The Social Security Amendments of 1983 (Public Law 98–21) however, brought new Federal workers, most current executive level political appointees, Members of Congress, and Federal judges into social security as of January 1, 1984. Since the beginning of 1983, all Federal employees have been paying taxes into social security's medicare (hospital insurance) trust fund and earning credits toward medicare coverage. (Additional effects of the Social Security Amendments of 1983 on civilian Federal employees are discussed in a separate section of this report.)

In general, workers covered by the current CSRS are eligible for an unreduced nondisability pension at age 55 with 30 years of service, at 60 with 20 years of service or at age 62 with 5 years of service (eligibility requirements and benefit levels for law enforcement officers, firefighters, air traffic controllers, and Members of Congress and congressional employees differ somewhat from those described here). Employees whose jobs are abolished or whose agencies are undergoing a major reorganization or reduction-in-force (RIF) are eligible for involuntary retirement at any age with 25 years of service or at age 50 with 20 years of service, but benefits are reduced by 2 percent for each year the retiree is under age 55 at the time of his or her retirement.

Regular retirement pensions are computed as a percentage of average annual salary during the highest 3 consecutive years of earnings (high-3). Employees earn 1.5 percent of their high-3 average annual salary for each of their first 5 years of service, plus 1.75 percent of their high-3 average salary for each of their next 5 years of service, plus 2 percent of their high-3 salary for each year of service thereafter. The total benefit may not exceed 80 percent of the retiree's high-3 average annual pay; this ceiling is reached after about 42 years of service.

CSRS provides disability pensions to employees with at least 5 years of service who are unable to continue working their Federal jobs due to disease or injury and who are not qualified for assignment to any vacant position in the same agency at the same pay scale and grade. CSRS also provides automatic survivor benefits for survivors of employees with at least 18 months of service. Benefits for survivors of retirees are provided unless the retiree and eligible survivors elect not to have such coverage at the time of retirement; survivor protection results in a reduced monthly annuity.

Cost-of-living adjustments (COLA) are paid annually, each December (January checks). COLA's are limited to price increases as measured by the CPI, and are based on the changes that occurred during the period between the third quarter of the year in which the COLA is made and the third quarter of the previous year.

Previous standing law had provided for COLA's annually (in March, based on price changes during the previous calendar year), but in recent years as a budget savings device, COLA's have been skipped and, in the case of nondisability retirees under age 62, reduced.

CSRS benefits are taxable as income after the beneficiary has received monthly payments equal to the amount withheld from the employee's paycheck (this portion of the benefit was taxed when it was originally earned). Benefits generally become taxable after about 14 months.

Cost and Financing of the Civil Service Retirement System

As table 1 shows, over the last 18 years the number of beneficiaries receiving pensions or survivor annuities under CSRS has grown by 165 percent.

Table 1.—CIVIL SERVICE RETIREMENT SYSTEM ANNUITANTS

[Yearend numbers in thousands]

Fiscal year	Total	Regular retirement	Noncategorized retirement	Disability	Survivors
1965	728	359		149	220
1970	960	478		185	297
1975	1,373	733		258	382
1980	1,674	904		343	427

Table 1.—CIVIL SERVICE RETIREMENT SYSTEM ANNUITANTS—Continued

[Yearend numbers in thousands]

Fiscal year	Total	Regular retirement	Noncategorized retirement	Disability	Survivors
1981	1,778	972		348	458
1982	1,829	1,009		349	471
1983	1,926		[2] 1,403		523
1984 [1]	1,980		[2] 1,445		535
1985 [1]	2,032		[2] 1,485		547

[1] Projected.

[2] Budget has only totals for retiring employees; fiscal year 1983, 1984, and 1985 do not break down into regular retirement and disability retirement.

Source: Office of Personnel Management, and Budget of the United States Government, fiscal year 1985, Appendix, p. I–V6.

Benefits paid under CSRS come from the civil service retirement system trust fund, an account within the Federal Treasury. Under the provisions of Public Law 91-93, CSRS trust fund assets are derived from four main sources:

(1) Employee contributions (7 percent of basic pay for most employees, 7½ percent for covered congressional employees and hazardous duty employees and 8 percent for covered Members of Congress);

(2) Matching contributions from employing agencies;

(3) Interest on trust fund assets; and

(4) Budget authority sufficient to amortize additional liabilities caused by wage increases and other changes affecting benefit awards (except COLA), to pay credit granted under CSRS for military service, and to pay interest on the "unfunded liability" (see text below for discussion of unfunded liability).

The effect of this arrangement is that trust fund income will always exceed fund outlays and the CSRS trust fund will continue to grow. Public Law 91-33 authorizes an automatic transfer from the Treasury to the CSRS trust fund to cover the last two categories of revenue. Annual appropriations to CSRS by Congress are not required, except to approve the matching contribution of each Federal agency contained in that agency's budget.

Of the four sources of trust fund revenue listed above, only the first actually adds funds to the Federal budget; the other three are merely transfers within the unified budget of the Federal Government. In fiscal year 1983, the CSRS trust fund received revenues totaling $34.31 billion, of which $4.28 billion came from employee contributions. Thus, employee contributions in fiscal year 1983 equalled slightly more than one-fifth of the $20.80 billion disbursed by CSRS during the same period.

At the end of fiscal year 1983, the CSRS trust fund had estimated assets of $109.55 billion. Although this balance is maintained by the U.S. Treasury as a separate account, any excess of fund income over benefit payments is always invested in special Government securities. In effect, this process allows the Federal Government to write itself an IOU note, promising that it will raise the necessary revenue through taxation or borrowing when the money is needed to pay benefits authorized under CSRS.

Although the CSRS trust fund has more than enough assets to fund *current* payments to *current* CSRS retirees, the combination of current assets and the present value of projected future revenues is considerably less than the present value of future benefits payable to current retirees and those current employees who will eventually become eligible for CSRS benefits. This difference is referred to as the "unfunded liability," and its size varies between $200 billion and over $500 billion, depending on actuarial assumptions made concerning future wage increases and cost-of-living adjustments. As long as the value of benefit *rights* earned by current employees continues to exceed revenue credited to the CSRS trust fund, the unfunded liability will continue to grow.

While Congress could add appropriations from the Treasury to eliminate the unfunded liability, these appropriations would immediately return to the Treasury in the form of securities held in trust for CSRS, because none of this new income would be needed to fund current payments to CSRS beneficiaries. The CSRS trust fund would show a higher balance, but this increase would be offset by an equal increase in the gross Federal debt. Neither CSRS beneficiaries nor Federal taxpayers would be affected by the change. The only change would be semantic—the transformation of unacknowledged statutory obligations ("unfunded liabilities") into acknowledged obligations ("assets").

Table 2.—CIVIL SERVICE RETIREMENT SYSTEM PAST AND PROJECTED FLOW OF ASSETS

[In billions of dollars, current]

Fiscal year	Employee payments	Government payments [1]	Interest on investments	Total CSRS revenues	Disbursements [2]	CSRS trust fund balance (end of fiscal year)
1970	1.74	1.95	0.99	4.68	2.75	22.43
1975	2.53	6.71	2.14	11.38	7.21	33.35
1980	3.69	15.56	5.14	24.39	14.98	73.69
1981	4.01	18.19	6.33	28.53	17.78	84.44
1982	4.14	19.45	7.84	31.46	19.48	96.01
1983	4.27	20.71	9.33	34.31	20.80	109.55
1984 [3]	4.40	20.70	10.60	35.70	22.60	122.20

Table 2.—CIVIL SERVICE RETIREMENT SYSTEM PAST AND PROJECTED FLOW OF ASSETS—Continued

[In billions of dollars, current]

Fiscal year	Employee payments	Government payments [1]	Interest on investments	Total CSRS revenues	Disbursements [2]	CSRS trust fund balance (end of fiscal year)
1985 [3]	4.60	21.70	11.70	38.00	24.20	136.00
2000 [3]	10.60	48.80	21.20	80.60	61.00	378.80

[1] Government payments (agency contributions, appropriations, interest on unfunded liabilities).

[2] Benefits, refunds, administrative expenses.

[3] These numbers for fiscal years 1984 and 1985 are OPM numbers using OPM economic assumptions found in CSRS annual report, September 30, 1982. Numbers in fiscal year 1985 budget are slightly different.

Source: Office of Personnel Management.

Cost-of-Living Adjustment Changes

Legislation enacted in 1982 by the 97th Congress affected the payment of cost-of-living adjustments. Standing law had required that COLA's equal to the percentage increase in the Consumer Price Index (CPI) over the previous calendar year be applied to civil service pensions each March 1. The Omnibus Reconciliation Act of 1982 (Public Law 97-253), however, suspended standing law pertaining to COLA's in pensions and survivor annuities for all Federal retirees for fiscal years 1983, 1984, and 1985. During these years, the 1982 act provided that COLA's would be effective 1 month later each year (i.e., April 1983, May 1984, and June 1985), and that retirees must be over age 62 or disabled to be assured of a full COLA. The act also required most military retirees employed in the civil service to have an amount equal to the COLA they received in their retired pay deducted from their civilian salary.

Fiscal Year 1984 Budget Proposals

In a series of changes in 1984, Congress eliminated the COLA which would have been paid in May and instead moved COLA to an annual December COLA beginning in 1984. Congress also repealed the other delays imposed by Public Law 97-253 and restored full COLA to under age 62 retirees. The COLA offset for military retirees in civilian employment was also repealed.

In its fiscal year 1984 budget proposals, submitted to the Congress in January 1983, the Reagan administration proposed legislation constraining COLA's and reducing benefits for civil service retirees. The administration, maintaining that CSRS is far more generous than typical private pension plans, proposed to:

(1) Limit the annuities of employees choosing to retire before age 65 by reducing the annuities of such retirees by 5 percent for each year under age 65 at the time of retirement. This change was to be phased in over a period of 10 years, and employees age 55 and over at the time of enactment would not have been affected;

(2) Cancel the May 1, 1984 COLA, with the next COLA effective June 1, 1985, as scheduled by the Omnibus Reconciliation Act of 1982; and provide regular retirement annuitants under age 62 COLA's equal to one-half the actual increase in the CPI, beginning in fiscal year 1986;

(3) Base annuities on the retiree's highest 5 years of earnings, instead of the highest 3;

(4) Sufficiently reduce the accrual rate used in determining CSRS retirement pensions so that the cost of the system would equal 22 percent of payroll, instead of the current 36 percent of payroll estimated by CSRS actuaries using dynamic assumptions;

(5) Increase employee contributions for civil service retirement to 9 percent of salary in 1984 and 11 percent in 1985. Assuming the adoption of the cost-cutting budget proposals described above, this increase in payroll deductions would have meant that employees were contributing approximately one-half of the estimated cost of their retirement system;

(6) Increase the matching agency contributions for retirement at the same rate as employee deductions, so that the Federal Government would also be formally financing one-half of the civil service retirement system; and

(7) Include all new Federal employees under social security coverage, as recommended by the National Commission on Social Security Reform.

Of these proposals, only the provision including new Federal employees under social security was enacted; no legislation containing the other proposals was ever submitted to Congress.

Social Security Coverage for Federal Employment

The Social Security Amendments of 1983 (Public Law 98–21) extends social security coverage to Federal employment, although it also exempts most *current* Federal workers from such coverage. The act requires the following categories of Federal civilian employees to be covered by social security, beginning January 1, 1984:

(1) All Federal employees hired on or after January 1, 1984, including those with previous periods of Federal service if the break in Federal service lasted at least 365 days;

(2) Congressional employees on the same basis as other Federal workers who become covered by social security because of the bill, and as well as current congressional employees who are not participating in the civil service retirement system on December 31, 1983;

(3) Sitting Federal judges;

(4) The Vice President and Members of Congress; and

(5) Most executive level and senior executive service political appointees.

The Social Security Amendments of 1983 also provide that retirees who become eligible for both social security and Government pensions after 1985 will be subject to a reduction in their social security benefits, phased in over a 5-year period. Under the current formula, social security benefits are based on the sum of 90 percent of the first $280 of average indexed monthly earnings (AIME), 32 percent of AIME from $280 thru $1,691, and 15 percent of AIME above $1,691 (these dollar amounts pertain to calendar year 1985 and are increased annually to reflect changes in average wages earned by covered workers). The act replaces the 90 percent factor with a 40 percent factor. The reduction is to be phased in over a 5-year period: 80 percent the first year, 70 percent the second, etc., to full effectiveness in the fifth year. Federal civilian employees exempted from this provision include current workers with 30 years of social security covered employment; those with 25 to 29 years of covered work have the reduction "stepped" at 10 percent for each year under 30—80 percent for 29 years, 70 percent for 28, etc.

At the time the social security amendments were passed in March 1983, no new civil service retirement system incorporating social security coverage had been enacted. If additional legislation had not been passed, beginning January 1, 1984, the personnel listed above would have begun contributing 6.7 percent of their salary up to the social security wage base of $37,800, into social security, in addition to the 7 to 8 percent of salary that they would contribute to CSRS. This formula would have placed an excessive financial burden on these Federal employees, and could have created problems in the recruiting and retention of personnel, according to a recent General Accounting Office memo to the House Post Office and Civil Service Committee.

Title II of the Federal Physicans Comparability Allowance Amendments of 1983 (H.R. 2077), known as the Federal Employees' Retirement Contribution Temporary Adjustment Act of 1983, eliminated this problem by defining how civil service employees covered by social security will be affected until a new CSRS incorporating social security coverage is enacted. In general, the act requires that civil service employees covered by social security because of the 1983 amendments make the full social security contribution, but have only 1.3 percent of their salaries withheld for the civil service retirement system between December 31, 1983 and January 1, 1986. Unless these employees deposit the difference between the amount withheld at the 1.3 percent rate and what would have been withheld at the 7 percent rate before they begin collecting their pension, however, the benefit earned during the years in which they contributed only 1.3 percent of their salary will be offset by the portion of their social security benefit earned during that period.

Members of Congress and executive level and senior executive service political appointees employed by the Government on or before December 31, 1983, were given an opportunity to select their

level of participation in the civil service retirement system. If they choose not to participate at all in CSRS they will not receive any pension from that system; they may participate at the 1.3 percent rate, in which case they will receive a pension offset by their social security benefit unless they deposit the difference between the amount withheld at the 1.3 percent rate and what would have been withheld at the full CSRS rate pertaining to them; or they may participate at the full rate, in which case they will receive both full social security and full CSRS benefits. The act also requires that any employee who first takes civilian office in the Government on or after January 1, 1984, who participates in CSRS, and who is affected by the social security amendments be subject to the new Government pension system when it is established. In addition, any credit earned toward the existing CSRS by any employee who is participating in CSRS on or after January 1, 1984, and who is required to join the new CSRS will be creditable only under the new CSRS. The act requires employing agencies to contribute at the same rate as they currently contribute for each employee.

Fiscal Year 1985 Budget Proposals

The fiscal year 1985 budget submitted by the Reagan administration proposed several important changes to the civil service retirement system. The administration proposed:

(1) To delay the COLA currently scheduled for June 1984 to January 1985, with all subsequent COLA's also effective in January. The 12-month period used to measure the increase in the Consumer Price Index would be changed to third-quarter over third-quarter;

(2) To repeal the provision of the Omnibus Reconciliation Act of 1982 (Public Law 97-253) which would have guaranteed retirees under the age of 62 a COLA of at least 3.3 percent in 1984;

(3) To provide COLA's equal to 100 percent of regular COLA's for the first $10,000 of each beneficiary's annuity, but to limit COLA's to 55 percent of the regular COLA for that portion of the annuity beyond $10,000. The $10,000 figure would be increased annually to reflect annual COLA's;

(4) Beginning in fiscal year 1986, provide civil service retirees and survivors with COLA's based on the lesser of the increase in the CPI or the increase in Federal white collar pay;

(5) To increase employee contributions to 8 percent of salary in 1985 and 9 percent of salary in 1986. Agency contributions would increase to match employee contributions;

(6) Based annuity calculations on the retiree's highest 5 years of earnings, instead of the highest 3, as is the current practice; and

(7) Prohibit District of Columbia employees hired after September 30, 1984 from joining CSRS.

The administration estimated that this reform package would increase receipts by $0.9 billion and reduce outlays by $0.4 billion in fiscal year 1985.

Current Reform Efforts

The President's Private Sector Survey on Cost Control (PPSSCC, or Grace Commission), submitted to the President a series of proposals which would dramatically alter the current retirement system for civil service employees. The Commission recommended:

(1) Raising the age at which retirees become eligible for unreduced pensions to 62 from the current 55;

(2) Increasing the current 2 percent reduction for each year under age 55 applied to retirement benefits for employees selecting involuntary retirement to a 4 percent reduction for each year under age 62;

(3) Changing the current "high-3" formula used for computing retirement benefits to a formula based on the highest 5 years of earnings;

(4) Eliminating the counting of unused sick leave as service for the purpose of computing retirement benefits;

(5) Removing the disability provision from CSRS entirely and establishing a separate long-term disability plan adhering to prevailing private sector practices;

(6) Changing the eligibility requirements and benefit formula for survivors of CSRS retirees;

(7) Basing COLA's for CSRS beneficiaries on the lower of the annual increases in the CPI or the annual increase in general schedule pay. Annuitants under age 62 would receive 33 percent of this increase; annuitants age 62 or older would receive 70 percent of this increase. Retirees whose annuities exceed the annuities to current retirees with the same Federal work histories would be limited to one-half of the COLA otherwise payable. COLA's for retirees age 62 and over who are eligible for fully-insured social security benefits would receive 33 percent of the increase; and

(8) Requiring mandatory social security coverage for all new Federal employees and all current employees under age 45. Employees age 45 and older would be given the option of social security coverage.

Unless substantial changes, such as those listed above, are made in the civil service retirement system, the Commission also recommended that CSRS employee contributions and matching agency contributions be raised immediately to 9 percent of salary.

Chapter 4

MILITARY RETIREMENT SYSTEM

(By Robert L. Goldich)

Background

The military retirement system covers members of the Regular and Reserve components of the Armed Forces, and consists of three major elements: nondisability retirement, disability retirement, and survivor benefits for eligible survivors of deceased military retirees. Statutory laws and common usage refer to these pension benefits as "retired pay." Members of the military do not contribute a percentage of their salary to help pay for retirement benefits; retirees electing survivor benefit coverage, however, do have their retired pay reduced by an amount which varies with the level of coverage chosen.

Military personnel have paid taxes into the social security trust funds since January 1, 1957, and are entitled to receive social security benefits based on their years of military service. Retirement annuities from the two systems are not integrated—military retirees receive social security benefits in addition to their retired pay. Payments to a surviving spouse under the survivor benefit plan (SBP), however, are offset by the amount of social security benefits earned by the deceased member through military service, if the surviving spouse is also receiving social security benefits. This offset may not exceed 40 percent of the SBP payment.

A servicemember becomes entitled to military nondisability retirement benefits upon completion of 20 years of service, regardless of his or her age. (The average enlisted person retires at age 39, the average officer at age 42.) A member who retires from active duty is paid an immediate monthly annuity based on a percentage of his final basic pay. Retired pay is computed at the rate of 2.5 percent of final basic pay for each year of service. The minimum amount of retired pay to which a member is entitled is therefore 50 percent of final basic pay (20 years $\times$ 2.5 = 50); the maximum, reached after 30 years of service, is 75 percent.

A member of the Reserves is also eligible to receive retirement benefits after 20 years of service, but does not begin collecting retired pay until age 60. The formula for computing retired pay for a reservist is the same as that used for an active member, but reservists accrue benefits on a point system which equates 360 points to 1

full year of service. The average reservist earns approximately 50 points each year.

Disability retired pay is provided to servicemembers who are found unfit for duty due to physical disability. In order to be eligible for such pay, a member must have either 20 or more years of service or a disability rated at 30 percent or more under standard rating schedules used by the Veterans Administration. Disability retired pay is computed in one of two ways, whichever is most beneficial to the member: (1) 2.5 percent of the member's basic pay multiplied by years of service, or (2) basic pay multiplied by the percentage of disability. Disability retired pay may not exceed 75 percent of basic pay.

Survivor benefits are payable to eligible survivors of a military retiree unless the retiree chooses not to be covered by the survivor benefit plan. A beneficiary may be a spouse, former spouse, dependent child, or other person with an insurable interest in the member. The monthly annuity may be as little as $300 or as much as 55 percent of the member's retired pay. The retired pay of a member participating in the SBP is reduced by an amount which varies with the level of coverage. Such deductions defray an estimated 70 percent of the cost of the SBP.

Retired pay and survivor annuities are protected against inflation. Standing law requires that each December a cost-of-living adjustment (COLA) equal to the increase in the average Consumer Price Index (CPI) between the third quarters of successive years be applied to the annuities of military retirees and their survivors. This standing law will take effect with the December 1985 COLA; the December 1984 COLA was determined by a provision of the Omnibus Reconciliation Act of 1982 (see section on Legislative Action, 1982–84).

Cost and Financing of the Military Retirement System

In fiscal year 1960, the Federal Government paid the 256,000 beneficiaries covered by the military retirement system $0.7 billion in retired pay and survivor annuities, an average per capita annuity of $2,700. In comparison, the Department of Defense (DOD) estimates that 1.2 million nondisabled retirees, 135,000 disabled retirees, and 95,000 survivors will receive a total of $17 billion in retired pay and survivor annuities in fiscal year 1984, for an average annuity of about $11,900.[1] By the year 2000, DOD projects that 1.9 million beneficiaries will be receiving approximately $43 billion in retired pay and survivor annuities, equaling a payment of $22,600 to each retiree and survivor.

Another method of measuring the cost of the military retirement system is as a proportion of total DOD outlays. In 1960, the military retirement system consumed about 2 percent of DOD outlays. In fiscal year 1984, DOD estimates that appropriations for retired pay and survivor annuities will equal about 7 percent of total DOD

[1] Unless noted, all dollar figures for current and future years are based on the Social Security Administration's intermediate (II–B) assumptions.

outlays, down from a peak of 9 percent in fiscal year 1980. If the administration's long-range defense spending goals are enacted, estimated outlays for the retirement system will shrink to about 6.5 percent of total DOD outlays in fiscal year 1985.

According to a Department of Defense valuation, as of the end of fiscal year 1983, the Federal Government's liability to pay retirement benefits to existing beneficiaries and to members then serving in the Armed Forces who would eventually become eligible for retirement benefits was approximately $710 billion, based on the Department's "most likely" economic forecast. This amount is generally referred to as the "unfunded liability." Until October 1, 1984, the military retirement system did not have a separate trust fund. (An accrual accounting system for military retirement was implemented beginning with fiscal year 1985. See section below on Legislative Action, 1982–84.) Military retirement benefits were funded entirely from general revenues, on a pay-as-you-go basis. Each year Congress was required to appropriate sufficient funds to cover the cost of retired pay and survivor annuities for that year. Thus, as is true for other Federal social insurance and pension programs, the ability of the military retirement system to continue paying the current level of benefits to eligible beneficiaries was dependent not on the assets of any trust fund, but on the political decision of Congress that the existing level of benefits was appropriate.

Table 1.—MILITARY RETIREMENT SYSTEM ANNUITANTS

[Actual yearend numbers]

Fiscal year	Total	Nondisability	Disability	Survivors' (number of families)
1960	256,007	168,398	85,297	2,312
1965	481,034	373,389	103,002	4,643
1970	772,789	620,013	144,885	7,891
1975	1,073,017	884,293	159,630	29,094
1980	1,330,150	1,113,429	151,096	65,625
1981	1,363,164	1,143,248	145,746	74,170
1982	1,390,779	1,171,328	142,105	77,346
1983	1,418,881	1,193,352	140,008	85,521
1984 [1]	1,451,208	1,219,202	136,215	95,291
1985 [1]	1,481,909	1,243,807	133,406	104,696
2000 [1]	1,923,956	1,592,738	90,658	240,560

[1] Projections.

Source: U.S. Department of Defense, Defense Manpower Data Center, Valuation of the Military Retirement System, Fiscal Year 1983, Office of the Actuary; and U.S. Department of Defense, Department of Defense Selected Manpower Statistics, Fiscal Year 1982.

Table 2.—DOD OBLIGATIONS FOR MILITARY RETIRED PAY AND SURVIVOR BENEFITS

Fiscal year	Millions of dollars	
	Current	Constant, 1983
1960	693	2,331
1965	1,386	4,377
1970	2,853	7,320
1975	6,239	11,549
1980	11,920	14,412
1981	13,724	15,033
1982	14,940	15,421
1983	15,932	15,932
1984 [1]	16,634	16,427
1985 [1]	17,207	16,847
2000 [1]	45,780	22,846

[1] Projections.

Source: U.S. Department of Defense, Office of the Actuary; U.S. Department of Defense, and Congressional Research Service, 1984.

Legislative Action, 1982–84

Legislation enacted in 1982 by the 97th Congress affected the payment of cost-of-living adjustments (COLA's), a key component of the military retirement system. Standing law at that time (10 U.S.C. 1401a) required that military retirees receive a COLA in their military retired pay at the same time and of the same percentage as that which civil service retirees received. COLA's in civil service retired pay were then effective each March 1, and were equal to the percentage increase in the Consumer Price Index (CPI) for the immediately preceding calendar year (5 U.S.C. 8340).

The Omnibus Reconciliation Act of 1982 (Public Law 97–253), however, suspended standing law pertaining to COLA's in retired pay and survivor annuities for all Federal retirees for fiscal years 1983, 1984, and 1985. The 1982 act provided that COLA's would be effective 1 month later each year (i.e., April 1983, May 1984, and June 1985), and that nondisabled retirees under age 62 would receive a reduced COLA. The act also required most military retirees employed by the Federal Government to have an amount equal to the COLA they received in their retired pay deducted from their civilian salary. These provisions were substantially altered in 1984 (see below).

The first session, 98th Congress also acted to modify certain provisions of the military retirement system. The 1984 Department of Defense Authorization Act (Public Law 98–94) approved the use of accrual accounting for the military retirement system, as requested by the administration. The act established a Department of Defense military retirement fund, administered by the Secretary of the Treasury. The purpose of the fund, which became operational

on October 1, 1984, is to finance on an "actuarially sound basis" liabilities incurred by DOD under the military retirement system. Starting in fiscal year 1985, the budget of each military service will reflect the amount of retirement pay to which current service members will become entitled in the future, as accrued under an aggregate entry-age normal cost funding method. Previously, the defense budget showed only the benefits paid to personnel who had already retired, and these benefits were listed as DOD-wide outlays, not broken down by service. The institution of accrual accounting is an accounting change only, involving several "paper transactions" within the unified budget but not affecting Government outlays at all. Even though accrual accounting will have no direct effect on Government outlays in the current or future years, proponents of the new system believe that it will improve personnel management by more accurately reflecting true personnel costs.

The 1984 Defense Authorization Act also contained several other provisions amending military retired pay and benefits. The act:

(1) Authorized the Government to round down to the next lowest whole dollar amount the monthly retired pay checks of military retirees, effective October 1, 1983. Similar authority applicable to other Federal retirees was enacted in 1982. DOD estimated that, although each retiree will only lose from $0.12 to $11.88 per year, this provision would save the Government $9 million each year through 1987.

(2) Repealed the 1 year "look-back" formula used for computing military retired pay. This formula allowed military retirees to base their retired pay on the pay scale in effect on the date of their retirement, or on the immediate preceding pay scale adjusted upward by any subsequent COLA's, whichever was greater. The repeal of this provision becomes effective in September 1986.

(3) Extended by 1 year (to October 1, 1985) the deadline for depositing the required 7 percent of wages earned through post-1956 military service into the civil service retirement fund in order for military retirees who choose to count their post-1956 military service toward civil service retirement to also be allowed to count these same years toward social security. Any deposits not made by the deadline will accrue an interest penalty.

In the 2d session of the 98th Congress (calendar year 1984) several pieces of legislation made major changes in military retirement COLA's. The President's fiscal year 1985 budget proposals, made in early 1984, originally proposed to:

—Repeal the provisions of the Omnibus Reconciliation Act of 1982 (1) authorizing COLA's effective May 1, 1984 and June 1, 1985, and (2) providing minimum COLA's based on an "assumed" CPI for nondisabled retirees under age 62.

—Permanently shift the payment date for Federal, civilian, and military retiree COLA's to January 1 of each year, beginning with January 1, 1985. (There would be no COLA be-

tween April 1, 1983 and January 1, 1985, cancelling the fiscal year 1984 COLA completely.) At the same time, the period of time over which the Consumer Price Index (CPI) is measured to determine the extent of the COLA increase would be modified to reflect the increase in average CPI between the third quarters of successive years (i.e., the COLA paid to Federal retirees on January 1, 1985 will be based on the percentage increase in the average CPI for the period June–September 1983 compared to the average for June–September 1984).

The administration estimated that enactment of these proposals would save approximately $400 million in civil service retirement and $300 million in military retirement outlays in fiscal year 1985. The fiscal year 1985 COLA for military retirees would cost an estimated $347 million.

Congressional action on military retired pay during the 2d session, 98th Congress, involved two separate pieces of legislation:

—*The Omnibus Reconciliation Act of 1983* (Public Law 98–270, approved April 18, 1984) basically accepted the President's proposal to shift the payment date for future military retirement COLA's. COLA's will now be paid to military retirees for the military retired pay that accrues during December of each year, beginning with December 1984. The fiscal year 1984 COLA previously scheduled for payment on May 31, 1984 in accordance with the provisions of the Omnibus Reconciliation Act of 1982 was cancelled.

—*The Deficit Reduction Act of 1984* (Public Law 98–369; approved July 18, 1984) eliminates completely the policy of providing reduced COLA's to nondisabled military retirees under age 62, effective with the fiscal year 1985 COLA which will accrue during December 1985. It also repealed the section of the Omnibus Reconciliation Act of 1982 which required most military retirees employed by the Federal Government to have an amount equal to their military retired pay COLA to be deducted from their civil service salary, in effect requiring them to forfeit their military retirement COLA's. Finally, it shifted the payment date for military retired pay from the last business day of the current month to the first business day of the next month; i.e., from the 30th or 31st of most months to the 1st of the following month. This provided 1 month—October 1984—in which there were no military retirement payments (the last fiscal year 1984 payment took place on September 30, 1984, and the first fiscal year 1985 checks were dated November 1, 1984), providing a one-time savings of $1.6 billion in fiscal year 1985 military retired pay outlays.

Current Reform Efforts

The increasing cost of the military retirement system has made it a frequent target of cost-cutting attempts. Three separate groups have been studying the military retirement system. The Presi-

dent's Private Sector Survey on Cost Control (PPSSCC, or Grace Commission), a group of leading business executives asked by President Reagan to examine Government practices, issued its final report on January 15, 1984.

The report recommended major changes in the military retirement system which would drastically reduce the level of benefits available to retirees. In contrast with the current absence of a minimum retirement age and the eligibility to retire with an immediate annuity at 20 years of service, under the Grace Commission proposal full annuities would not be available to military retirees until age 62; actuarially reduced annities would be available to retirees age 55, with no receipt of an annuity permitted under age 55. Vesting, however, would take place with 10 years of military service rather than the current 20, with persons separating from military service with more than 10 years of service but less than 20 eligible for deferred annuities at age 55 or later on the same basis as noted above. These changes would apply to personnel with fewer than 10 years of service upon enactment and future entrants; those with more than 10 years of service would be "grandfathered" into the current system.

The annuity computation formula would be applied to the highest 5 years of basic pay (rather than the current final basic pay, or highest 3 years for members entering military service after September 7, 1980), and would be reduced from 2.5 percent of the base multiplied by the number of years of service to approximately 2.1 percent. These changes would be "grandfathered" for all personnel within 3 years of retirement at the time of enactment, and all military service performed under the old system would continue to earn retirement pay at the old 2.5 percent rate.

The Grace Commission also recommended restricting cost-of-living adjustments (COLA's) for military retirees. Under-62 retirees would initially receive either the annual percentage change in the CPI or the annual percentage increase in active duty military compensation, whichever was lower. Upon reaching age 62, and becoming eligible for social security, retirees would receive only one-third of the annual increase in the CPI. There would be no indexing of the annuity amount between the date an early (pre-55) retiree separated from active duty and actually began receiving military retired pay. All of these provisions would be effective immediately upon enactment.

Finally, the Grace Commission would offset that portion of social security benefits attributable to military service against retired pay; this provision would be phased in during a 4-year period after enactment and would not be "grandfathered."

The Congressional Budget Office has estimated that the Grace Commission proposals would reduce budget authority by $6.6 billion in fiscal year 1985 and a total of $42.6 billion during fiscal years 1985–89. Due to the accrual accounting system recently established for military retirement, actual outlay savings would be much less, amounting to $300 million in fiscal year 1985 and $2.6 billion during fiscal years 1985–89. The Grace Commission itself did

not produce estimates of outlay savings, but estimated budget authority savings of $28.1 billion in the first 3 years after the changes were fully implemented, as compared with CBO's estimate of $32.7 billion for the same period.[2]

The Fifth Quadrennial Review of Military Compensation (QRMC), an internal DOD study group established in accordance with law (37 U.S.C. 1008(b)) which requires that DOD conduct a review of military compensation every 4 years and submit recommendations to the Congress for change, if necessary, submitted its final report on retirement to the Secretary of Defense in January 1984. The QRMC's preferred alternative to the current military retirement system involves reducing the COLA for under-62 retirees to 75 percent of the CPI; changing the annuity computation formula from the current 50 percent of basic pay at 20 years of service to 35 percent, the percentage to increase approximately 3 percent yearly until the 75 percent mark is reached at 30 years of service, as is currently the case; and allowing an "early withdrawal" in cash of two times annual basic pay for officers and three times for enlisted personnel upon reaching the 20 years of service mark.

Current retirees and military personnel would be exempted from all changes except for the reduced COLA; active duty members with fewer than 12 years of service would have the option of remaining under the current system or joining the new pension plan. CBO estimates that the new system would reduce budget authority by $1.6 billion in fiscal year 1985, but outlay savings would amount only to about $68 million.

Finally, Congress has begun its own preliminary review of the military retirement system. Representative Aspin, Chairman of the House Armed Services Subcommittee on Military Personnel and Compensation, initiated hearings on the military retirement system during the summer of 1984, declaring that "a review is now long overdue." The subcommittee heard testimony from representatives of the Office of the Secretary of Defense, PPSSCC, QRMC, and General Accounting Office.

Fiscal Year 1985 Budget Proposals

The fiscal year 1985 budget proposed by President Reagan contained no proposals for major structural change in the military retirement system. The administration did propose numerous changes in COLA provisions, discussed above in the section on Legislative Action, 1982–84. Action on major structural change will almost certainly not come before early 1985, when Congress begins action on the fiscal year 1986 budget. In an April 9, 1984 memorandum to the Secretary of Defense, Presidential National Security Adviser Robert C. McFarlane stated that due to the complexity of the issue, the President desired recommendations for changes in military retirement policy based on the Fifth Quadrennial Review of Military Compensation to be forwarded to him not later than

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[2] Analysis of the Grace Commission's Major Proposals for Cost Control. A joint study by the Congressional Budget Office and General Accounting Office. Washington, February 1984: 37.

December 30, 1984, thus foreclosing further action during calendar year 1984. Political considerations and the pressures of an election year congressional schedule made further action during 1984 virtually impossible.

Chapter 5

RAILROAD RETIREMENT

(By Dennis Snook and Michael Burke)

The railroad retirement system (RRS) is a federally legislated, industry financed retirement system providing retirement, survivor, and disability protection for workers with at least 10 years of railroad employment. The system is administered by the Railroad Retirement Board. With the exception of the dual benefit payments (windfalls), the principle guiding railroad retirement system (RRS) financing is that the rail industry is responsible for a level of taxation upon industry payroll sufficient to pay all benefits earned in industry employment. Other Federal taxpayers are not to be responsible for costs of the RRS. Accordingly, rail industry management and labor officials participate in shaping legislation that establishes the system's benefits and taxes. In this process, Congress weighs the relative interests of railroads, their current and former employees, and Federal taxpayers. Then it guides, reviews, and to some extent instructs a collective bargaining activity, the results of which are reflected in new law. Thus, railroad retirement benefits are earned in and paid by the railroad industry, established and modified by Congress, and administered by the Federal Government.

Financing

Railroad retirement benefits have two components that are paid to all retirees; tier I and tier II benefits. Tier I benefits are similar to social security and tier II benefits constitute an industry pension. In addition, a benefit known as a "windfall" is paid to a closed group of about one-third of the nearly 1 million beneficiaries, those who had dual entitlement to railroad retirement and social security before 1975. The "windfall" benefit is financed directly by the Federal Government through general revenue appropriations.

The tier I benefit, roughly equivalent to social security, is coordinated with the social security program for two reasons. First, to insure that workers covered as railroad retirees receive at least the same benefits they would have received had they been covered under social security. (This includes a provision for transferring to the social security program any credits earned by employees who die or retire with less than 10 years service in the railroad indus-

try.) Second, that neither the social security nor the railroad retirement financing mechanisms are disadvantaged by railroad retirees' receiving tier I benefits.

To the extent that tier I benefits are identical to social security, they are financed through the social security program. There is no cross-program subsidy, however, in this "financial interchange." Money collected through the tier I tax on rail payroll that would have been collected by social security were railroad retirement not to exist is transferred to social security. Money for benefits paid by railroad retirement that would have been paid by social security is transferred from that program to the railroad retirement account (RRA).

Table 1.—WINDFALL BENEFIT PAYMENTS AND AVERAGE NUMBER OF WINDFALL BENEFICIARIES

[Dollars in millions]

Fiscal year	Windfall benefits [1]	Average number of beneficiaries (in thousands)
1983	$429	354
1984	420	330
1985	405	308
1986	392	293
1987	375	276
1988	355	257
1989	345	243
1990	325	232

[1] Assumes full funding of the windfall benefit.

Source: Railroad Retirement Board, 1984.

Before 1975, the railroad industry financed windfall benefits. (The windfall benefit is the amount by which the combination of the social insurance earned in railroad employment and actual social security benefits exceed the social security benefit that the beneficiary would receive if all his earnings had been covered by social security alone.) After deciding to eliminate future opportunities to qualify for windfall benefits in 1974, the Congress agreed to fund the phaseout period for existing windfall benefits. Since 1981, Congress has financed windfall benefits through appropriations to a special account established within the railroad retirement program. (Table 1 shows benefit projections for this class of beneficiaries.)

The railroad industry and its employees are responsible for (1) the financing of all tier II benefits, (2) any tier I benefits received under different criteria than would be provided under social security, called "unrecompensed benefits," and (3) benefits payable under the unemployment and sickness program, other than those paid

through supplemental extended benefits legislation that expired June 30, 1984. (As was true under the Federal-State unemployment program, these supplemental extended benefits were paid from general funds.)

Under current law, tier II benefits and unrecompensed tier I benefits are financed by taxes on industry payroll. The tax rate was 12.75 percent on employers and 2.75 percent on employees, in 1984, and was increased by 1 percentage point on employers, and 0.75 percentage point on employees on January 1, 1985 and is scheduled to rise again on January 1, 1986. Until the 1983 amendments, the maximum tax bases in both tier I and tier II were on a monthly basis and so was subject to the seasonal fluctuation of railroad employment. The maximum taxable wage base is now on an annual basis ($29,700/year in 1985). Any funds collected during an accounting period that exceed disbursement during that same period are added to the railroad retirement account and invested in Federal Treasury securities that are guaranteed as to both principal and interest.

Tier I benefits are financed through a tax that is identical to social security, currently 7.05 percent of the first $39,600 income for employers and employees, in 1985.

Unemployment benefits are financed by a tax rate on employers of 8 percent of each employee's first $600 of monthly earnings. Since 1959, Congress has allowed the railroad unemployment insurance account (RUIA) to borrow from the railroad retirement account (RRA) whenever its income and balances were insufficient to cover benefits. The law requires these loans to be repaid with interest. The sum owed to the RRA by the RUIA is treated as an asset of the RRA and interest is added to the balance equal to the rate of return earned by other RRA investments. While loans from the RRA to the RUIA are treated as an asset, they cannot be cashed in to provide immediate liquidity and so they can create an additional strain on the railroad retirement account. This borrowing authority expires at the end of fiscal year 1985. After fiscal year 1985 the RUIA account is projected to incur unfunded liabilities of roughly $70 to $90 million annually between fiscal year 1986 and fiscal year 1990.

Financial Status

Over the last decade or so, the rail industry has suffered a gradual decline in traffic. This decline has resulted in diminished employment in the rail industry. (See table 2.) Because the railroad retirement and railroad unemployment programs are financed by taxes on industry payrolls, declines in rail employment mean lower revenues are generated to support those two programs. The sensitivity of these funds to levels of employment cannot be over-emphasized (see table 3) although it is important to recognize that the relationship between employment levels and fund revenue is largely mechanical and does not necessarily mean that the rail industry has less money to support the earned benefits of its employees. In fact, to the extent that declines in employment are a direct result

of improved worker productivity, it could be argued that the industry's capacity to meet its obligations is actually improved by that decline. Nevertheless, in every fiscal year in the past decade, except 1977, benefit payments have exceeded income to the trust funds thereby drawing down the railroad retirement trust fund reserves.

In 1981, Congress enacted legislation recommended by representatives of railroad labor and management that was intended to assure financial stability in the retirement system, at least through the end of this decade. These changes included: tax increases, benefit cuts, and a separation of the windfall benefits into a separate congressionally funded account, thereby preventing it from depleting the railroad retirement account.

Table 2.—AVERAGE RAILROAD EMPLOYMENT FOR 1973 TO 1983 AND PROJECTED FOR 1984–89

[In thousands]

Calendar year	Average number of workers
1973	584
1974	592
1975	548
1976	540
1977	546
1978	542
1979	554
1980	532
1981	505
1982	440
1983	388

	Employment assumptions		
	I	II	III
1984	395	395	400
1985	380	380	375
1986	365	365	351
1987	355	350	342
1988	345	335	335
1989	335	320	314
1990	325	305	295
1995	285	260	230
2000	260	235	176

Source: Railroad Retirement Board, 1984.

Table 3.—RAILROAD RETIREMENT TRUST FUND BALANCES, FISCAL YEAR 1975 THROUGH FISCAL YEAR 1989

[In millions of dollars]

Fiscal year	Trust fund balance (end of year) under alternative employment assumptions			Actual fund balance
	I	II	III	
1974				
1975				4,284
1976				3,950
Transitional quarter				3,157
1977				2,929
1978				2,773
1979				2,658
1980				2,252
1981				1,627
1982				922
1983				346
1984	2,323	2,323	2,365	
1985	2,320	3,320	3,313	
1986	4,595	4,595	4,507	
1987	5,116	5,084	4,940	
1988	5,339	5,242	5,087	
1989	5,486	5,280	5,072	
1990	5,597	5,234	4,937	
1995	5,280	3,764	2,195	
2000	5,039	1,476	−3,633	

[1] Taxes, interest on investments, appropriations for windfalls, net financial interchange.

[2] Benefits, net transfers to administration.

[3] Includes amounts owed to this account.

Source: Railroad Retirement Board, 1984.

However, these changes did not solve railroad retirement financing problems for long. The recession of 1981–82 caused a dramatic drop in railroad jobs—over one-fourth of the industry's jobs were lost between 1981 and 1983, thus precipitating an immediate and severe threat to the capacity of the railroad retirement fund to meet its benefit payments. Without additional legislation, a provision in the 1981 refinancing legislation that was adopted to assure the continuation of social security equivalent benefits (tier I) would have required benefit cuts to the industry pension portion of benefits (tier II) of 40 percent to begin as of October 1, 1983.

The dramatic reduction in jobs also meant less income to the railroad unemployment fund at precisely the time more benefit demands on that fund were being made. Because shortages in the unemployment fund are borrowed from the retirement fund, any solution to railroad retirement financing involves addressing the unemployment fund shortfall as well.

Because neither Congress nor rail labor and management wanted such a sharp decrease in railroad retirement benefits to occur, rail industry representatives at the direction of Congress, sought to reach agreement on a package of changes acceptable to Congress and the Reagan administration that would build up the railroad retirement trust fund.

In February 1983, railroad labor and management representatives agreed to a package of changes to build up the trust funds. Those recommendations, incorporated in the Railroad Retirement Solvency Act of 1983 (Public Law 98-76), were approved by both Houses and signed into law in sufficient time to avert the October 1 benefit cuts.

The 1983 Amendments

The railroad retirement amendments of 1983 responded to two major problems: (1) taxes were too small to support scheduled benefits for current retirees, and (2) a serious short-term cash flow problem existed because of the amount and timing of revenues into the main railroad retirement account.

The 1983 amendments changed railroad retirement benefits in two substantial ways. Provisions permitting retirement at age 60 after 30 years of railroad service were modified and the cost-of-living adjustments in tier I were offset by reductions in tier II benefits. (Other benefit changes were made to conform the railroad retirement benefits to social security.)

Before the 1983 amendments, a railroad worker with 30 years service could retire at age 60 and have his social security equivalent (tier I) benefit calculated as if he were age 65 (under social security, earliest eligibility is age 62 with benefits reduced by 20 percent). The 1983 amendments changed the railroad retirement early retirement program; workers will now be expected to work to age 62 to receive unreduced benefits. Workers retiring at age 60 will have their tier I benefit reduced by 20 percent. This change substantially reduces payments from the railroad retirement fund that are "unrecompensed." (The difference between what a railroad worker would receive in tier I benefits in such cases as retirement at age 60 and what the same worker would have received had he been covered under social security is not financed by social security through the financial interchange.) The change is being phased in as follows: workers who have 30 years of service *and* who reached age 60 before July 1, 1984, are eligible under the old rules regardless of when they actually retire. Workers who will have reached eligibility for retirement at age 60 between July 1, 1984 and December 31, 1985, will face one-half of the reduction (10 percent).

The cost-of-living adjustments (COLA) are to be made on the same dates as social security adjustments. The next 5 percentage points in COLA applied to tier I benefits after enactment were offset dollar-for-dollar in tier II benefits, but in no case were tier II benefits to be reduced to less than $10 per month. Because the rate of price increase did not cause the next COLA to be at least 5 per-

cent, the offset was applied partially in 1984 (3.5 percent) and 1985 (1.5 percent).

There will be three increases in the tier II (or private industry pension) payroll tax. Effective January 1 of the first 3 successive years, tier II taxes on rail employers are raised by 1 percentage point and on employees by 0.75 percentage point. The third increase will come on January 1, 1986.

In addition, rail employers now pay the unemployment insurance tax rate on the first $600 of monthly employment, an increase of 50 percent over the previous $400 wage base. A further unemployment tax will be imposed between July 1, 1986 and September 30, 1990 to help repay a debt owed by the unemployment account to the retirement account. The tax will start at 2 percent of the first $7,000 in annual wages and will increase by 0.3 percentage point each subsequent January 1.

Starting in 1984, tier II benefits became treated as taxable income under the same terms as private pensions. Revenue will be transferred to the railroad retirement account until fiscal year 1989 or until the amount tranferred equals $877 million. Windfall benefits will also be taxable with revenue transferred to the railroad retirement account until 1989, and thereafter to the dual benefits payment account (windfall benefit account).

Other significant changes encompassed in the 1983 amendments concern the repayment of the windfall shortfall between fiscal year 1975 and fiscal year 1981 and changes in the borrowing authority. The railroad retirement account will be permitted to draw against outstanding amounts due that account for social security, thus gradually making current the financial interchange between the social security account and railroad retirement. The outstanding difference between the amount paid by the Railroad Retirement Board in windfall benefits and that which was appropriated by Congress between fiscal year 1975 and fiscal year 1981 (including interest) will be paid to the railroad retirement account in three equal installments on January 1 of each of 3 successive years. The first such payment was made in January 1984.

The 1983 amendments also established a five-member Railroad Unemployment Compensation Committee for the purpose of reviewing all aspects of the railroad unemployment program. It submitted a report to Congress on June 29, 1984. The committee was composed of two labor representatives, two management representatives, and one public member. The committee report stated, "The members of the committee could not agree on the question of whether the railroad unemployment insurance system should continue as an independent system, or whether it should be merged with the Federal/State unemployment insurance system. . . . The committee unanimously reached agreement as to how the RUI system should be appropriately revised if it is [sic] maintained as a separate system and its financial solvency were to be restored" The two labor members believed that any proposal to cover the railroad industry under the Federal/State system would be unacceptable.

Longrun Outlook

The railroad retirement program appears to have no longrun financing problems under all but the most pessimistic employment assumptions. Railroad employment peaked at 1.68 million in 1945 and has steadily declined to its current level of less than 400,000. The beneficiary rolls from earlier periods of high railroad employment have started to decline and are expected to continue to decline in the future. (See table 4.)

The administration's fiscal year 1985 budget contained no proposals for changing the railroad retirement system but did propose to transfer responsibility for railroad unemployment insurance to the States. While the administration proposed dismantling the retirement system in its fiscal year 1983 budget, the enactment of the Railroad Retirement Solvency Act of 1983 is expected to preclude any immediate major change to railroad retirement. Legislation pertaining to railroad unemployment compensation will likely be debated in the 99th Congress.

Table 4.—PROJECTED NUMBER OF MONTHLY BENEFICIARIES

Year	Number
1983	981,780
1984	968,000
1985	951,000
1986	932,000
1987	917,000
1988	903,000
1989	886,000
1990	867,000
1995	767,000
2000	653,000

Source: Railroad Retirement Board, 1984.

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